Supreme Court, U.S.
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No. _____

In the Supreme Court of the United States

WALTER L. AND BARBARA H. GROSS, JR.;
CALVIN C. AND PATRICIA G. LINNEMANN,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON PETITION FOR WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

PETITION FOR WRIT OF CERTIORARI

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QUESTION PRESENTED

Petitioner Taxpayers, relying on a longstanding interpretation by the Commissioner of Internal Revenue of the willing buyer/willing seller standard for the valuation of gifts for tax purposes, paid taxes on gifts of S Corporation stock that they made to their children. The Commissioner, however, abandoned this longstanding and settled administrative practice in favor of a new interpretation of the valuation standard, and then used that theory to raise Petitioners' tax liability retroactively in the context of a United States Tax Court litigation rather than promulgating prospective, formal regulations. The question presented is whether the Commissioner's actions violated principles of administrative law and due process established by this Court and followed by other courts of appeals, and contravened the Congressional policy against retroactive tax liability?

PARTIES TO THE PROCEEDING

The parties below were petitioners Walter L. and Barbara H. Gross, Jr. and Calvin C. and Patricia G. Linnemann (Petitioners-Appellants below) and respondent Commissioner of Internal Revenue (Respondent-Appellee below).

TABLE OF CONTENTS

QUESTION PRESENTED i

PARTIES TO THE PROCEEDING ii

TABLE OF AUTHORITIES v

OPINIONS BELOW 1

JURISDICTION 1

PERTINENT PROVISIONS 1

STATEMENT OF THE CASE 1

REASONS FOR GRANTING THE WRIT 8

I. THE PANEL MAJORITY'S DECISION IS INCONSISTENT WITH BASIC ADMINISTRATIVE LAW AND DUE PROCESS PRINCIPLES ADOPTED BY THIS COURT, WITH DECISIONS APPLYING THOSE PRINCIPLES IN OTHER COURTS OF APPEALS, AND WITH CONGRESSIONAL INTENT 8

A. Conflict With Decisions Of This Court 9

B. Conflict With Decisions Of Other Courts Of Appeals 12

C. Conflict With Congressional Intent 14

II. THE COURT OF APPEALS ERRED IN UPHOLDING TAXPAYERS' TAX DEFICIENCIES 18

III. THIS DECISION IN THIS CASE HAS IMPORTANT AND SWEEPING CONSEQUENCES 19

CONCLUSION 24

APPENDIX

Appendix A
Order of the United States Court of Appeals for the Sixth Circuit, Denying the Petition for Rehearing, dated March 21, 2002 . . . . . 1a

Appendix B
Opinion of the United States Court of Appeals for the Sixth Circuit, dated November 19, 2001 . . . . . 3a

Appendix C
Memorandum Findings of Fact and Opinion of the United States Tax Court, dated July 29, 1999 . . . . . 50a

Appendix D
Statutory and Regulatory Provisions, Title 26. Internal Revenue Code, Subtitle B. Estate and Gift Taxes. 26 USCS § 2512 (2002) 80a

Appendix E
Code of Federal Regulations. Title 26. Internal Revenue. Chapter I. Subchapter B. Estate and Gift Taxes. 26 CFR 25.2512-1 . . . . . 81a

Appendix F
Code of Federal Regulations. Title 26. Internal Revenue. Chapter I. Subchapter B. Estate and Gift Taxes. 26 CFR 25.2512-2 . . . . . 83a

TABLE OF AUTHORITIES

Cases

Adams v. Commissioner,
T.C. Memo 2002-80, 83 T.C.M. (CCH)
1421 (March 28, 2002) 12

Automobile Club of Michigan v. Commissioner,
353 U.S. 180 (1957) 17

Bowen v. Georgetown Univ. Hosp.,
488 U.S. 204 (1988) 9, 12, 16

Central Illinois Public Serv. Co. v. United States,
435 U.S. 21 (1978) 15, 16

Commissioner v. Estate of Hubert,
520 U.S. 93 (1997) 19

Curry v. Block,
738 F.2d 1556 (11th Cir. 1984) 13

Dickman v. Commissioner,
465 U.S. 330 (1984) 16, 17

Estate of Bright v. United States,
658 F.2d 999 (5th Cir. 1981) 13, 14

Farmers' and Merchants' Bank v. United States,
476 F.2d 406 (5th Cir. 1973) 15, 16

Ford Motor Co. v. FTC,
673 F.2d 1008 (9th Cir. 1981) 13

Freytag v. Commissioner,
501 U.S. 868 (1991) 13

Hall v. Commissioner, 34 T.C.M. (CCH) 648 (1975) . . 7

Health Ins. Ass'n of America, Inc. v. Shalala,
23 F.3d 412 (D.C. Cir. 1994) 14

Longhi v. Animal & Plant Health Inspection Serv.,
165 F.3d 1057 (6th Cir. 1999) 12

Maris v. Commissioner,
41 T.C.M. (CCH) 127 (1980) 7

Massey Motors, Inc. v. United States,
364 U.S. 92 (1960) 16

Matzke v. Block,
732 F.2d 799 (10th Cir. 1984) 13

Montgomery v. Aetna Plywood, Inc.,
39 F. Supp. 2d 915 (N.D. Ill. 1998) 22

Morton v. Ruiz,
415 U.S. 199 (1974) 9, 10, 12

NLRB v. Bell Aerospace Co.,
416 U.S. 267 (1974) 10, 12, 13

NLRB v. Majestic Weaving Co.,
355 F.2d 854 (2d Cir. 1966) 12

NLRB v. Wyman-Gordon,
394 U.S. 759 (1969) 9

Pfaff v. HUD,
88 F.3d 739 (9th cir. 1996) 13

Reich v. Valley Nat'l Bank,
837 F. Supp. 1259 (S.D.N.Y. 1993) 21

Roth v. Sawyer-Cleator,
16 F.3d 915 (8th Cir. 1994) 21

SEC v. Chenery Corp.,
332 U.S. 194 (1947) 9, 10, 12

Sirbo Holdings, Inc. v. Commissioner,
509 F.2d 1220 (2d Cir. 1975) 11

Thomas Jefferson Univ. v. Shalala,
512 U.S. 504 (1994) 20

United States v. Byrum,
408 U.S. 125 (1972) 14

United States v. Cartwright,
411 U.S. 546 (1973) 3

Statutes and Regulations

26 U.S.C. §2512(a) 3
26 U.S.C. §7805(b) 8, 14, 15, 17

I.R.C. §§1361-1379 . . . . . 3, 21

Treas. Reg. §25.2512-1 3
Treas. Reg. §25.2512-2(a) 3

Other

H. Rep. No. 104-506, reprinted in 1996 U.S.S.C.A.N. 1143 . . . . . 14, 15

Rev. Rul. 50-60, 1959-1 C.B. 237 3

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IRM 4350, Examination Technique Handbook for Estate Tax Examiners, 8(11)9 (Dec. 16, 1987) 7

IRS Valuation Guide for Income, Estate and Gift Taxes, p.7-14 (Jan. 28, 1994) 7

James H. Zukin, Financial Valuation: Business and Business Interests ¶8.2 (1990) 22

PETITION FOR A WRIT OF CERTIORARI

Walter L. and Barbara H. Gross, Jr. and Calvin C. and Patricia G. Linnemann respectfully petition for a writ of certiorari to review the judgment of the United States Court of Appeals for the Sixth Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App. 3a) is reported at 272 F.3d 333. The opinion of the tax court (App. 50a) is reported at 78 T.C.M. (CCH) 201.

JURISDICTION

The judgment of the court of appeals was entered on November 19, 2001. A timely petition for rehearing and suggestion for rehearing en banc was denied by that court on March 21, 2002. App. 1a. This Court has jurisdiction under 28 U.S.C. §1254(1).

PERTINENT PROVISIONS

Pertinent provisions of the Internal Revenue Code and Treasury Regulations are reproduced at App. 80a.

STATEMENT OF THE CASE

This case presents a question of exceptional importance to anyone involved in or affected by the valuation of a small business corporation ("S Corporation") nationwide. It also broadly concerns when the IRS is allowed to act retroactively through litigation rather than promulgating new prospective regulations when it wants to change the tax laws. Specifically, this case marks the first time that the IRS,

departing from years of prior practice, has taken the position that anyone who attempts to value an S Corporation using its predicted future earnings cannot reduce such earnings by deducting hypothetical, future corporate income taxes. This novel position affects not only valuations for gift and estate tax purposes, but also countless other valuations of S Corporations, especially those done in the context of Employee Stock Ownership Plans ("ESOPs"). Indeed, the case was recently called a "landmark ruling" that "extends into every area of business valuation and is without a doubt the most significant business valuation case in the last 20 years."[1]

The IRS asserted its position, not under the guise of a formal rulemaking, which would have given Petitioners and other taxpayers adequate notice of the IRS's new position, but in litigation against these Taxpayers in the tax court. The question presented is whether, given this Court's expression of disfavor for an agency's establishment of policy solely in litigation, Congress' clear expression of intent that tax rules should not be applied retroactively, and this Court's own pronouncements regarding when agencies should engage in rulemaking, the Commissioner acted improperly in retroactively imposing tax liability on Taxpayers based on a novel position taken for the first time in the context of a court litigation. Because of the importance of this case and because the court of appeals decision conflicts with decisions of other courts of appeals and of the United States Supreme Court, Petitioners request a writ of certiorari.

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[1] See Hawkins & Paschall, A Gross Result in the Gross Case: All Your Prior S Corporation Valuations Are Invalid, Fair Value (Fall 2001) (submitted to court of appeals on January 28, 2002).

The substance of this case concerns how the stock of an S Corporation should be valued. It arises here in the context of gift taxation, but the same valuation standard is followed in numerous other contexts. Under the tax laws, the value of a gift of stock is the stock's fair market value on the date the gift was made. I.R.C. §2512(a) (26 U.S.C. §2512(a)); Treas. Reg. §25.2512-2(a). App. 80a, 83a. The fair market value of property is defined as the price at which the property would change hands between a hypothetical willing buyer and willing seller where neither is under any compulsion to buy or sell, and both have reasonable knowledge of the relevant facts. This is the well-established willing buyer/willing seller rule. See App. 22a-23a; United States v. Cartwright, 411 U.S. 546, 551 (1973); Treas. Reg. §25.2512-1, App. 81a; Rev. Rul. 59-60, 1959-1 C.B. 237.

The taxpayer Petitioners made gifts to their children in July 1992 of shares of stock in an Ohio corporation called G&J Pepsi Cola Bottlers, Inc. ("G & J" or "the company"). App. 6a-7a. The company is structured as an S Corporation under Subchapter S of the Internal Revenue Code, I.R.C. §§1361-1379. An S Corporation pays no federal income tax. Instead, the shareholders report their respective shares of the corporation's income on their individual tax returns (whether that income is actually distributed or not). App. 5a-6a. In reporting the value of the gifts to the IRS, the taxpayers relied on an appraisal report that set the value of G & J stock at $5,680 per share as of May 31, 1992. App. 7a. Petitioners paid gift taxes totaling $1,802,361.00 on the gifts based on this per share amount. App. 7a; (See Stipulation of Facts pp.2-3).

The Taxpayers' valuation employed a discounted future cash flow method whereby the company's present value was determined by projecting its future income and

discounting the value of those cash flows to the present. App. 8a-9a. In accordance with standard valuation practice, the Taxpayers' appraisal reduced G&J's future income by deducting hypothetical federal and state corporate income taxes of 40% even though such taxes would not actually be paid if the company remained an S Corporation. This process, known as "tax affecting," was and has been the standard practice of professional business appraisers. App. 9a. There are a number of reasons why tax affecting is accepted under the willing buyer/willing seller rule. For example, tax affecting may serve as a proxy for other hard-to-quantify disadvantages of S Corporation status that a buyer would consider. In addition, the likely hypothetical willing buyer of an S Corporation is not another S Corporation, but a C corporation that will have to pay taxes on income attributed to the S Corporation's assets once purchased. See, e.g., K.Aschwald & D.Walker, Valuing S Corporation ESOP Companies, 11 Jl. of Employee Ownership L. and Finance 1 (1999) (Attached as Exhibit B to Petitioners' Petition for Panel Rehearing and Petition for Rehearing En Banc). The Taxpayers' appraisal also discounted the value of the stock by 35% to reflect the stock's lack-of-marketability based on the fact that the shares of an S Corporation cannot readily be bought and sold like stock in a publicly-traded company. App. 10a.

In 1996, the Commissioner of Internal Revenue, over four years after the gift had been made, issued notices of deficiency to the Taxpayers, contending that the value of the G&J stock in 1992 was $11,738 per share, almost double the 1992 appraised value. App. 7a. In the subsequent tax court litigation, the IRS took the novel position that under the willing buyer/willing seller standard, tax affecting was not appropriate for the valuation of S Corporations and that the

lack-of-marketability discount should be significantly reduced from levels approved in the past.

These notices of deficiency came as a complete surprise to the Taxpayers in light of similar past transactions approved by the Commissioner. In 1988, the Taxpayers had made similar gifts of stock based on a valuation appraisal applying the same 40% tax-affecting earnings deduction and 35% lack-of-marketability discount they relied on in valuing the 1992 gifts at issue in this case. (Trial Ex. 19-J); App. 32a. The same valuation approach was also used in 1990 in the context of a valuation of G&J shares held by the estate of the son of the Linnemann petitioners. (Trial Ex. 14-I). The IRS was well aware of both of the respective valuations, having conducted an investigation of the 1988 gift tax return and a review of the 1990 estate tax return. (Trial Exs. 16, 17, 18, 23, 24). But the IRS in neither instance challenged the valuation methods or the amount of taxes paid.

The IRS's position with respect to the 1992 gifts amounted to a retroactive application, through litigation, of new rules regarding tax affecting and marketability, to the Taxpayers, contrary not only to the IRS's own prior practice with respect to these Taxpayers, but also to generally accepted valuation practice and the IRS's own practice as evidenced by its own documents and the only case law touching on these issues. (See App. 29a-32a). The retroactive application of the new position is especially egregious in the present case because the willing buyer/ willing seller test for fair market value necessarily attempts to replicate the price that a hypothetical willing buyer and a hypothetical willing seller would have reached at the time the original transaction was consummated.

The court action in this case began on March 10, 1997 when the Taxpayers filed petitions with the tax court for a redetermination of the deficiencies. At trial, the IRS relied solely on the "expert" testimony of Mukesh Bajaj, Ph.D, who presented an entirely novel methodology, developed specifically for this case, in support of the IRS's new position that tax affecting is inappropriate for S Corporation valuations and that the methodology used to compute lack-of-marketability discounts is not valid. Prior to trial, the taxpayers vigorously contended that Bajaj's testimony was inadmissible under Daubert. The tax court, however, disagreed and allowed Bajaj to testify. App. 11a-12a. Taxpayers relied on two expert business appraisers, David O. McCoy, who had issued the original 1992 appraisal of G&J stock and had performed the appraisals the IRS approved in 1988 and 1990, and Charles A. Wilhoite, an experienced appraiser of S Corporations. App. 57a-58a.

The tax court upheld the Commissioner's determination on July 29, 1999 (App. 50a) and the Taxpayers appealed to the Sixth Circuit Court of Appeals. On November 19, 2001, that Court, in a partially-divided panel decision, upheld the decision of the tax court. App. 3a. The panel upheld without dissent the tax court's application of a lower lack-of-marketability discount than that used by Taxpayers but divided on whether the tax court's conclusion that G&J's earnings should not be tax affected was clearly erroneous.

Senior District Judge Cohn, sitting by designation, writing for himself and Judge Daughtrey, determined that the IRS's decision not to tax affect the stock in determining its fair market value was appropriate. In rejecting Taxpayers' argument that the IRS's retroactive imposition of new valuation standards without promulgating new regulations was

improper and a violation of due process, Judge Cohn concluded that such actions were justified under the guise of "correcting an error." App. 48a.

Judge Clay dissented from the panel's decision on tax affecting, finding that the tax court clearly erred in its determination of the tax deficiency. Among other things, Judge Clay found that it was inappropriate for the IRS to apply retroactively, through litigation, such a modification of the willing buyer/willing seller standard. According to Judge Clay, in two previous reported tax "cases the tax court did use after-tax earnings in valuing the stock of S corporations." App. 29a. See Maris v. Commissioner, 41 T.C.M. (CCH) 127, 138 (1980) and Hall v. Commissioner, 34 T.C.M. (CCH) 648, 667 (1975). Moreover, Judge Clay also discussed two separate IRS publications that endorsed the same tax affecting method that the IRS abandoned in this case. (App. 30a) (citing IRS Valuation Guide for Income, Estate and Gift Taxes, p.7-14 (Jan. 28, 1994) (Trial Ex. 60) and IRM 4350, Examination Technique Handbook for Estate Tax Examiners, 7(11)9 (Dec. 16, 1987) (Trial Ex. 61)).

The IRS had never suggested, until this litigation in the tax court, that it disapproved of the caselaw or disavowed any of the statements in its own publications. Thus, the IRS had maintained a certain interpretation of the willing buyer/willing seller standard that Taxpayers had relied upon when they paid their taxes on the gifts at issue. In fact, the magnitude of the Commissioner's complete about-face in this matter is starkly illustrated by the statement of two commentators that all valuations of S Corporations in this country were rendered invalid by this case. (See supra, n.1).

REASONS FOR GRANTING THE WRIT

I. THE PANEL MAJORITY'S DECISION IS INCONSISTENT WITH BASIC ADMINISTRATIVE LAW AND DUE PROCESS PRINCIPLES ADOPTED BY THIS COURT, WITH DECISIONS APPLYING THOSE PRINCIPLES IN OTHER COURTS OF APPEALS, AND WITH CONGRESSIONAL INTENT

Under the guise of permitting the Commissioner to "correct[] an error," the panel majority erroneously permitted the Commissioner to add to a legal norm by retroactively imposing a new rule regarding the valuation of closely-held corporations in the context of this court litigation. The valuation method proffered by the IRS in the tax court in 1996 was not the interpretation of the willing buyer/willing seller standard that it held in 1992 when the transaction was consummated. It was not only contrary to established valuation practice, but also, as Judge Clay noted, contrary to the IRS's own published interpretation of law. As this Court has recognized, the litigation context is generally inappropriate for the imposition of new standards of conduct that upset the settled expectations of parties who depend on agency consistency and fairness. This principle is especially true in light of Congress' explicit desire that tax liability not be imposed or increased retroactively. See 26 U.S.C. §7805(b).

Prior to this case and the testimony of the IRS's expert, Mukesh Bajaj, in 1996, the IRS had never taken the position that, under the willing buyer/willing seller standard, future S Corporation earnings must not be tax affected nor had it mandated a lack-of-marketability discount using the

new analytical model Bajaj created. Taxpayers cited both case law and the IRS's own documents in support of their valuation approach and both of their experts testified that their 1992 gift tax returns were legally compliant. Moreover, taxpayers were comforted by and relied on the fact that the IRS had previously reviewed and approved similar transactions in 1988 and 1990 that employed the exact valuation method that they used in conjunction with the 1992 transactions. Thus, the IRS's interpretation of how the gifts in this case should be valued in accordance with law represents a complete reversal of its longstanding practice and interpretation of the same law.

A. Conflict With Decisions Of This Court

This Court has placed strict limits on the power of an agency like the IRS to act retrospectively. See, e.g., Bowen v. Georgetown Univ. Hosp., 488 U.S. 204 (1988). This is especially true where an agency attempts to change its position in the context of litigation and not through official agency rulemaking. See id. at 473-74. While the Court has recognized that an agency has some power to formulate policy through internal agency adjudications, that power is circumscribed. See SEC v. Chenery Corp., 332 U.S. 194 (1947). Indeed, the Chenery Court stated that ad hoc agency adjudication is not the preferred method of announcing new standards of conduct where rulemaking power exists. Id. at 202 ("the function of filling in the interstices of the Act should be performed, as much as possible, through [] quasi-legislative promulgation of rules to be applied in the future"); accord, e.g., Morton v. Ruiz, 415 U.S. 199, 236 (1974); NLRB v. Wyman-Gordon, 394 U.S. 759, 764 (1969) (plurality op.) (rulemaking procedure "may not be avoided by the process of making rules in the course of adjudicatory proceedings. There is no warrant in law for the [NLRB] to

replace the statutory scheme with a rule-making procedure of its own invention.").

While the Chenery decision declined to impose a hard and fast rule on when prospective rules must be adopted, it clearly circumscribed the situations appropriate for the promulgation of new principles through adjudication. Specifically, the Court noted that while an agency has to retain flexibility to act through adjudications, such action is appropriate only where problems arise that the agency "could not reasonably foresee, problems which must be solved despite the absence of a relevant general rule"; where an agency "may not have sufficient experience with a particular problem"; or where the problem is "so specialized and varying in nature as to be impossible of capture within the boundaries of a general rule." Id. at 202-03.

As this Court later made clear, it is especially inappropriate for an agency to change the rules outside of a rulemaking where individuals have relied on prior agency practice. In NLRB v. Bell Aerospace Co., 416 U.S. 267 (1974), where the Court approved the NLRB's decision to set certain standards by adjudication and not through rulemaking, the NLRB did not depart from a seemingly well-established standard as the IRS did in this case. The Bell Aerospace Court, in fact, specifically noted that "this is not a case in which some new liability is sought to be imposed on individuals for past actions which were taken in good-faith reliance on Board pronouncements, nor are fines or damages involved here." 416 U.S. at 295. Thus, the Court contrasted those situations where an agency might impose monetary liability based on conduct that was seemingly acceptable at the time taken. For example, in Morton v. Ruiz, decided in the same term as Bell Aerospace, the Court held that an agency could not "extinguish[]" the "legitimate expectation" of

certain Indians via an "unpublished ad hoc determination" as opposed to through a "legislative-type rule." 415 U.S. at 236.

There is no question that under the prevailing analysis this case is not appropriate for action through adjudication under this standard. This case presents no unique problems or issues that the IRS was not aware of in the years prior to these 1992 gifts, particularly with respect to these Taxpayers whose G&J stock was the subject of prior, similar valuations. The same general willing buyer/willing seller standard has prevailed for over 40 years. In addition, S Corporations, like the one involved in this case, have been exempt from corporate taxation since their inception.[2]

Moreover, there is little indication that the Commissioner now views the valuation of S Corporations, at least with respect to the methodology at issue in this case, as proper for case-by-case treatment only. In fact, at trial, the Commissioner's expert testified that it was "absolutely" wrong to tax-affect the earnings of an S Corporation in any situation. (See Trial Tr. 377, 386-87). Thus, what the Commissioner presented in this case was a complete reversal,

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[2] Contrary to the panel majority's suggestion below, this is not simply a case of error correction by the IRS. This is not a case where the Taxpayers were seeking to expand on one erroneous decision by the IRS to apply a certain rule in a particular case. See, e.g., Sirbo Holdings, Inc. v. Commissioner, 509 F.2d 1220, 1222 (2d Cir. 1975). Rather, this case involves complete abandonment of longstanding IRS policy in the area of valuation.

in the form of a generalized rule, of his prior valuation practice.[3]

B. Conflict With Decisions Of Other Courts Of Appeals

Within the general framework of Chenery and consistent with this Court's decisions in Bell Aerospace and Morton, the courts of appeals have recognized, in decisions that are flatly inconsistent with the decision in this case, that an agency cannot formulate ad hoc rules where doing so would be unfair or violate due process rights. Such situations include proscribing conduct or imposing a financial penalty for conduct that would have been permissible at the time of the conduct. See, e.g., NLRB v. Majestic Weaving Co., 355 F.2d 854, 860 (2d Cir. 1966) ("a decision branding as 'unfair' conduct stamped 'fair' at the time a party acted, raises judicial hackles considerably more than a determination [expanding agency jurisdiction]"); Longhi v. Animal & Plant Health Inspection Serv., 165 F.3d 1057, 1061 (6th Cir. 1999) (citing Bowen) (Department of Agriculture could not adopt a new licensing prohibition in the context of an agency adjudication rather than formally amending the regulations where that prohibition constituted "an 'agency litigating position' wholly unsupported by the text of the existing regulations").

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[3] The Commissioner continues to advocate his new position in other cases using the decision in the present case for support. Specifically, for example, recently in Adams v. Commissioner, T.C. Memo. 2002-80, 83 T.C.M. (CCH) 1421 (March 28, 2002), the IRS pressed a position advocating the abandonment of tax affecting, which the court accepted, citing the decision in the present case in support.

Similarly, in Pfaff v. HUD, 88 F.3d 739, 748 (9th Cir. 1996), the Ninth Circuit rejected HUD's attempt to impose a new standard on certain parties through adjudication. The court noted that it is inappropriate to do so "where the new standard, adopted by adjudication, departs radically from the agency's previous interpretation of the law, where the public has relied substantially and in good faith on the previous interpretation, where fines or damages are involved, and where the new standard is very broad and general in scope and prospective in application." Id. (citing, inter alia, Bell Aerospace, 416 U.S. at 295); accord, e.g., Ford Motor Co. v. FTC, 673 F.2d 1008, 1009-10 (9th Cir. 1981) ("an agency must proceed by rulemaking if it seeks to change the law and establish rules of widespread application"); Curry v. Block, 738 F.2d 1556, 1563-64 (11th Cir. 1984); Matzke v. Block, 732 F.2d 799, 802-03 (10th Cir. 1984).

The present case is even more egregious because the IRS's actions took place in the context of a court proceeding and not in the context of an internal agency adjudication. In the latter, at least the fiction can be maintained that the agency is making some reasoned policy. Such is not the case in a direct court action where the policy change is placed in the hands of agency litigators.[4]

In Estate of Bright v. United States, 658 F.2d 999 (5th Cir. 1981), the court rejected the IRS's attempt to abandon a

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[4] The tax court is not an agency but is an Article I court that "exercises judicial, rather than executive, legislative, or administrative, power" and thereby "exercises a portion of the judicial power of the United States." Freytag v. Commissioner, 501 U.S. 868, 890-91 (1991).

longstanding legal position involving stock valuation for estate tax purposes in a federal court action. In that case, the court noted that "the law should be stable and predictable. . . . especially [ ] in the tax laws, because there is widespread reliance by taxpayers upon established tax principles in planning their affairs." Id. at 1006; see also Health Ins. Ass'n of America, Inc. v. Shalala, 23 F.3d 412, 424-25 (D.C. Cir. 1994) (distinguishing between retroactive application of interpretive rules "in the context of internal adjudicatory procedures," which may be permissible versus in a "direct action in court," which is not permissible).

C. Conflict With Congressional Intent

The general principle of promoting fairness for taxpayers espoused in Bright has now been formalized by Congress. While Congress has recognized that it may be necessary for the Treasury Department and the IRS to promulgate certain rules and regulations in the tax area, see 26 U.S.C. §7805, Congress has now established that such rules and regulations are not to apply retroactively except in certain narrow circumstances, see id. §7805(b).[5]

In support of the "Taxpayer Bill of Rights 2,"the House Ways and Means Committee stated that "it is generally inappropriate for Treasury to issue retroactive regulations." H. Rep. No. 104-506, reprinted in 1996 U.S.S.C.A.N. 1143,

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[5] In United States v. Byrum, 408 U.S. 125, 135 (1972), this Court noted that Congress should generally handle changes in taxation, as opposed to courts: "When a principle of taxation requires re-examination, Congress is better equipped than a court to define precisely the type of conduct which results in tax consequences."

1167. The House Ways and Means Subcommittee on Oversight further explained:

> The complexity of the tax regulations and the lengthy period of time it takes the IRS to publish them, creates a significant hardship for taxpayers who seek in good faith to comply with the statutory tax law in the period of time before the regulations are published. If the taxpayer interprets the law in a way which is different from the position taken in a subsequent regulation, the taxpayer may be subject to additional taxes, penalties, and interest. The Subcommittee believes taxpayers should have more protection from the retroactive application of regulations.

House Ways and Means Subcmte. on Oversight, 104th Cong., 2d Sess., Explanation of Taxpayer Bill of Rights 2 (1995). Even formal regulations should not have an effective date any earlier than the date when the public is first made aware of the expected contents of those regulations either through Federal Register publication or otherwise. 26 U.S.C. §7805(b)(1).

Thus, in the context of formally adopted rules and regulations, Congress has emphasized that it is fundamentally unfair to subject taxpayers to tax liability based on a new interpretation of the tax laws applied retroactively. Even under the prior version of 26 U.S.C. §7805, which gave the IRS broader discretion to give regulations retroactive effect, that discretion was not unfettered. See, e.g., Farmers' and Merchants' Bank v. United States, 476 F.2d 406, 409-10 (5th Cir. 1973) (impermissible for IRS to abandon longstanding administrative practice through retroactive revenue ruling); Central Illinois Public Serv. Co. v. United States, 435 U.S.

21, 34 (1978) (Brennan, J., concurring). It is immaterial whether the prior practice, later abandoned, was formally embodied in a published regulation or not. Farmers' and Merchants' Bank, supra.[6]

In previous briefing in this case, the Commissioner has suggested that its actions in this case were not fundamentally unfair under this Court's decision in Dickman v. Commissioner, 465 U.S. 330 (1984).[7] Whatever the legal force of some of the language in Dickman, it is clear that that force has been blunted in the years since Dickman was decided. Specifically, Dickman was decided before this Court's decision in Bowen, which circumscribed an agency's ability to act retroactively generally and cast doubt on an agency's ability to act solely through litigation. More

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[6] See also Massey Motors, Inc. v. United States, 364 U.S. 92, 118-19 (1960) (Harlan, J., dissenting) (rejecting Commissioner's reversal of a prior position and noting that "it should make no difference that the Commissioner's earlier different practice was not embodied in a formal regulation"). The Massey Motors majority did not disagree with Justice Harlan's position on this point because it determined that the Commissioner had not, in fact, acted inconsistently with its prior practice. 364 U.S. at 100-01.

[7] The Commissioner in the present case has specifically cited language from Dickman suggesting that the Commissioner may change an earlier interpretation of law and apply it retroactively in the context of a court litigation without running afoul of due process. 465 U.S. at 343. That language, however, is plainly dicta given the Dickman Court's apparent decision that the Commissioner had not, in fact, taken an inconsistent position, id. at 343 & n.11, and that, due to the timing of the transactions, the taxpayers could not have relied on the Commissioner's alleged earlier position, id. at 343 & n.13.

importantly, Dickman was decided before Congress expressed in the Taxpayers Bill of Rights 2 its very clear disapproval of the ability of the IRS to impose or increase tax liability retroactively. Allowing the Commissioner to act retroactively through litigation would negate Congress' express intent.

* * * * *

The panel majority below suggested that the Commissioner's actions in this case were justified under the guise of "error correction." App. 48a (citing cases). There was, however, no error in this case to correct. Instead, the IRS simply departed from past practice in arguing for greater tax liability in the tax court. A doctrine designed to prevent a taxpayer from escaping genuine tax liability because of an IRS mistake does not support retroactively changing a tax rule in the context of litigation, thereby doubling the liability of an unsuspecting taxpayer.[8]

The Taxpayers in this case paid tax on their gift transactions based on the value that a willing buyer and

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[8] That this doctrine regarding the ability of the Commissioner to correct clear "mistakes of law" was relied on by the Dickman Court to support a more general statement that the Commissioner can simply "change an earlier interpretation of the law," further illustrates the tenuous nature of this aspect of Dickman. See Dickman v. Commissioner, 465 U.S. at 343 (citing Dixon v. United States, 381 U.S. 68, 72-75 (1965); Automobile Club of Michigan v. Commissioner, 353 U.S. 180, 183-84 (1957)). It should also be noted that both of the latter cases relied on in Dickman were also decided under the previous version of 26 U.S.C. §7805(b), which gave much broader retroactivity discretion to the IRS.

willing seller would have placed on the stock in 1992 when the gifts were made. The Commissioner came in years later to foist new and unexpected rules on the Taxpayers by disallowing tax affecting of G&J's future earnings stream and altering the traditional methodology for calculating the lack-of-marketability discount. This type of retroactive rulemaking, which results in unexpected, additional financial liability is inappropriate under this Court's own precedent and is inconsistent with numerous decisions in other circuits as well as the clearly expressed will of Congress.

II. THE COURT OF APPEALS ERRED IN UPHOLDING TAXPAYERS' TAX DEFICIENCIES

Once the Commissioner's inappropriate attempt to impose on these Taxpayers his new rule regarding what the willing buyer/willing seller standard permits is rejected, it is apparent that the additional tax liability for the 1992 gifts cannot stand. The overarching question in this case is what price a willing buyer and willing seller would have reached, assuming full information on the part of both, for the stock in question in 1992. The taxes Petitioners paid on the gifts were based on a valuation performed by the same professional appraiser who used the same methodology to value the same S Corporation stock for two recent, similar valuation events. That expert testified for Taxpayers at trial. The Commissioner's arguments in support of additional taxes were based solely on a radically different interpretation of the law presented for the first time in the tax court in this case. Because the Commissioner simply cannot retroactively change the law in this manner, the valuation relied on by Petitioners in accordance with 1992 methodologies and standards must prevail. As a result, no additional taxes are owed by

Petitioners on the 1992 gifts and the court of appeals and tax court decisions must be reversed.

III. THIS DECISION IN THIS CASE HAS IMPORTANT AND SWEEPING CONSEQUENCES

The importance of this case has two separate components. The procedural component implicates the power of the Commissioner to act at the expense of taxpayers by formulating new interpretations of law and imposing enhanced tax liability retroactively. The substantive component concerns the huge potential impact of the decision in this case on hundreds of millions of dollars in recently and currently performed valuations of S Corporations not only for tax purposes but other, less obvious purposes as well.

The impact of allowing the Commissioner to promulgate new interpretations of law, and apply new rules and regulations, in a litigation context, retrospectively is apparent. Congress has now indicated that it does not want changes in the tax laws to apply retroactively. Decisions like the one in this case, however, allow the Commissioner to sidestep that policy by eschewing formal regulations in favor of adopting and implementing tax law changes that affect substantive tax liability through litigation.

In addition, allowing the Commissioner to proceed like he did in this case exacerbates the prevailing taxpayer frustration over the complexity of tax laws and regulations. Justice O'Connor, for example, has expressed her own frustration with the "maze of regulations" already promulgated by the IRS. Commissioner v. Estate of Hubert, 520 U.S. 93, 122 (1997) (opinion concurring in the judgment). At least one commentator has stated that "[i]t is

beyond cavil that many provisions in Treasury Regulations are complicated and difficult to decipher." Dembitzer, Beyond the IRS Restructuring and Reform Act of 1998: Perceived Abuses of the Treasury Department's Rulemaking Authority, 52 Tax. Law. 501, 518 (1999). But despite their complexity, at least formal regulations are written down and accessible to taxpayers. The decision by the court of appeals in this case allows the Commissioner to create an additional layer of uncertainty by disregarding completely any semblance of notice or due process to the numerous taxpayers who hold S Corporation stock.[9]

With respect to the substance of the valuation issue, the proper interpretation of the willing buyer/willing seller standard in the context of S Corporations presents an issue that will have a wide impact beyond the parties in this case. The panel's decision ratifies the IRS's own change of position regarding the propriety of tax affecting S Corporation earnings for valuation purposes and, as some commentators have noted, will not only have an impact on all future valuations of S Corporations for gift and estate tax purposes but calls into question every such recent S Corporation valuation not protected by the limitations period. (See supra, n.1). The tax affecting issue generally has been the subject of much discussion in valuation literature. See, e.g., Valuing S

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[9] Moreover, as Justice Thomas has recognized, generally allowing agencies the ability to act through litigation discourages them to promulgate understandable and clear regulations: "It is perfectly understandable . . . for an agency to issue vague regulations, because to do so maximizes agency power and allows the agency greater latitude to make law through adjudication rather than through the more cumbersome rulemaking process." Thomas Jefferson Univ. v. Shalala, 512 U.S. 504, 525 (1994) (dissenting opinion).

Corporation ESOP Companies, supra. As a result, the Gross case has itself been the subject of literature and presentations. See, e.g., C.Glass & S.Mueller, Analysis of the Gross Case, Prepared for the American Society of Appraisers 19th Annual Advanced Business Valuation Conference (Nov. 2000).

Another reason this decision has stirred so much consternation among those who value businesses in this country is that it also impacts valuations of S Corporations for non-tax purposes, including most significantly, valuations of S Corporation stock held by Employee Stock Ownership Programs ("ESOPs"). ESOPs are employee benefit plans that invest primarily in employer securities. See, e.g., Roth v. Sawyer-Cleator, 16 F.3d 915, 917 (8th Cir. 1994). Since January 1998, ESOPs have been allowed to be shareholders in S Corporations. I.R.C. §1361(c)(6). Furthermore, because of the tax treatment of ESOPs, any earnings attributable to S Corporation shares owned by the ESOP shareholder are not subject to federal income tax (other shareholders are taxed on their pro-rata share of the S Corporations's income). Thus, ESOPs owning shares in S Corporations have become extremely popular and more common.

Numerous valuation issues arise with respect to ESOPs. See generally N.Goldberg, ESOP Valuation Issues, in ERISA Fiduciary Law 213-30 (1995 & Supp. 2000). For example, under ERISA, which generally governs retirement plans like ESOPs, certain ESOP transactions are "prohibited" unless "adequate consideration" is either paid or received. Id. at 214. In assessing whether "adequate consideration" was paid or received for stock, however, a valuation must be done. Id.; see Reich v Valley Nat'l Bank, 837 F. Supp. 1259, 1282-83 (S.D.N.Y. 1993). Moreover, the law now requires all ESOPs to have their shares appraised annually.

Montgomery v. Aetna Plywood, Inc., 39 F. Supp. 2d 915, 922 (N.D. Ill. 1998).

The wrong result in this case will have an effect on many ESOP valuations because appraisers who value S Corporation shares owned by ESOPs must follow the same "fair market value" willing buyer/willing seller standard set forth in Rev. Rul. 59-60 and followed by the IRS. See, e.g., Montgomery, 39 F. Supp. 2d at 919-20; Aschwald & Walker, Valuing S Corporation ESOP Companies, 11 J. of Employee Ownership L. and Finance 1, 3 (1999); ESOP Valuation Issues, supra, at 215. The Secretary of Labor has issued proposed regulations that address the valuation issue. (Proposed Regulation Relating to the Definition of Adequate Consideration, 53 Fed. Reg. 17632 (to be codified at 29 C.F.R. §2510.3-18) (proposed May 17, 1988)). These regulations, although merely "proposed" at this time, are "widely considered and followed" and held by many to be "authoritative." Montgomery, 39 F. Supp. 2d at 919 n.1 (citing James H. Zukin, Financial Valuation: Business and Business Interests ¶8.2 (1990)). See also ESOP Valuation Issues, supra, at 214-16. The proposed regulations specifically "embrace[] the valuation guidelines contained in Revenue Ruling 59-60 issued by the Internal Revenue Service." ESOP Valuation Issues, supra, at 215. This Revenue Ruling is the same ruling that governs the valuation in the present case. App. 23a-24a.

In sum, the decision below has caused widespread uncertainty and justifiable anxiety for the appraisal profession and its many clients over the acceptable methodology for valuing S Corporation shares owned by ESOPs, as well as all other current and future S Corporation valuations for gift and estate tax purposes. In addition to this serious practical impact on many people, there exists the disturbing implication

that, contrary to precedent and the will of Congress, it is now permissible for the Commissioner to alter radically substantive tax provisions retroactively through litigation. Clearly, this is a case warranting review by this Court.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be granted and the decision below reviewed by this Court.

Respectfully submitted,

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APPENDIX A

UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

99-2239/99-2257

[Filed March 21, 2002]

WALTER L. GROSS; BARBARA H. GROSS,	)
Petitioners-Appellants,	)
v.	)
COMMISSIONER OF INTERNAL REVENUE,	)
Respondent-Appellee.	)

JUDGES:
BEFORE DAUGHTREY and CLAY, Circuit Judges; and COHN,* District Judge.

* Hon. Avern Cohn, Senior United States District Judge for the Eastern District of Michigan, sitting by designation.

OPINION

The court having received a petition for rehearing en banc, and the petition having been circulated not only to the original panel members but also to all other active judges of this court, and less than a majority of the judges having favored the suggestion, the petition for rehearing has been referred to the original panel.

The panel has further reviewed the petition for rehearing and concludes that the issues raised in the petition were fully considered upon the original submission and decision of the cases. Accordingly, the petition is denied.

APPENDIX B

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

99-2239/99-2257

[Filed November 19, 2001]

WALTER L. GROSS, JR. and BARBARA H. GROSS (99-2239);	)
CALVIN C. LINNEMANN and PATRICIA G. LINNEMANN (99-2257), Petitioners-Appellants,	)
v.	)
COMMISSIONER OF INTERNAL REVENUE, Respondent-Appellee.	)

On Appeal from the United States Tax Court
Nos. 97-04460; 97-04469
James S. Halpern, Tax Court Judge

JUDGES:

Before DAUGHTREY and CLAY, Circuit Judges; COHN, Senior District Judge.* CLAY, J., announced the judgment of the court and delivered an opinion, in which DAUGHTREY, J., and COHN, D. J., concurred except as to Part II.B.1. COHN, D. J. delivered a separate opinion, in which DAUGHTREY, J. concurred, which constitutes the opinion of the court on the issue addressed in Part II.B.1.

OPINION

CLAY, Circuit Judge. Taxpayers, Walter L. and Barbara H. Gross, Jr., along with Calvin C. and Patricia G. Linnemann, appeal from the order of the United States Tax Court valuing certain gifts of corporate stock at $ 10,910 per share. To the extent that the valuation was based upon the use of a contested valuation approach, I would find that the tax court's decision was clearly erroneous; and would therefore reverse the tax court's decision and remand for further proceedings. However, inasmuch as Judge Daughtrey and Judge Cohn find that the tax court did not clearly err in concluding that it was appropriate not to tax affect the stock in order to determine its fair market value, the tax court's decision is **AFFIRMED**.

FACTS

The common question presented by this consolidated

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* The Honorable Avern Cohn, Senior United States District Judge for the Eastern District of Michigan, sitting by designation.

appeal is the fair market value of certain shares of corporate stock transferred as gifts by Taxpayers Walter L. Gross, Jr., and Patricia G. Linnemann to their respective children. Taxpayers Barbara H. Gross and Calvin C. Linnemann, the wife and husband of the aforementioned taxpayers, are parties because they consented to having the gifts made by their respective spouses as also having been made one-half by them for federal gift tax purposes. The shares in question are shares of stock of Pepsi-Cola Bottlers, Inc. ("G&J"), an Ohio corporation that bottles and distributes various beverages in Ohio and Kentucky. G&J's business operations can be traced back to a partnership formed in the 1920s between two married couples, Isaac N. and Esther M. Jarson and Walter L. and Nell R. Gross. This business was incorporated in 1969. By the time the questioned gifts were made in 1992, the founders of the corporation were deceased and ownership of G&J had devolved to their relatives: the Gross family group (which included members of the Linnemann family) and the Jarson family group. Directly and through voting trusts, each family group owned 50% of the outstanding shares of stock of G&J.

By a written agreement dated November 1, 1982, G&J's shareholders elected to be taxed as a small business corporation ("S corporation"), pursuant to Subchapter S of the Internal Revenue Code, I.R.C. §§ 1361-1379, for at least 10 years. This subchapter was enacted to eliminate the tax disadvantages that might dissuade small businesses from adopting the corporate form and to lessen the tax burden on such businesses. The statute accomplishes these goals by means of a pass-through system under which corporate income, losses, deductions, and credits are attributed to individual shareholders in a manner akin to the tax treatment

of partnerships. *See* I.R.C. §§ 1366-1368; *Bufferd v. Commissioner,* 506 U.S. 523, 524-25, 122 L. Ed. 2d 306, 113 S. Ct. 927 (1993). In practical terms, this means that the corporation pays no state or federal income tax. *See* I.R.C. § § 1361-1363; Ohio Rev. Code Ann. § 5733.09(B) (Banks-Baldwin 1995). Rather, the S corporation passes its income through to its shareholders, who report their *pro rata* shares of that income on their individual tax returns. *See* I.R.C. § 1366. G&J maintained S corporation status through July 31, 1992, at which time there were no plans to change its S corporation status.

Also in 1982, the members of the Gross/Linnemann family group entered into an agreement restricting the transferability of their G&J stock. This restrictive agreement permitted certain transfers within the Gross/Linnemann family group, but provided that if other transfers were attempted, the G&J stock would be purchased by the family group at book value.[1] More importantly, the agreement also restricted any transfers that would jeopardize G&J's S corporation status. This agreement was still in effect as of July 31, 1992.

At that time, G&J was the third largest independent bottler of Pepsi-Cola products. G&J had an exclusive franchise agreement to distribute these products within several geographic territories. These products, including the brand names Seven-Up, Dr. Pepper, and five variations of Pepsi-Cola, were distributed to over 24,000 customers including

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[1] Members of the Jarson family group entered into a similar restrictive agreement regarding their G&J shares on April 1, 1983. This agreement was also in effect as of July 31, 1992.

wholesale and retail outlets. G&J's operational infrastructure included plants, warehouses, over 800 vehicles, and over 11,000 soft drink vending machines. From 1988 to 1992, G&J enjoyed steady increases in its operational income, total income, and distribution to shareholders. In addition, G&J's shareholder distributions nearly totaled the company's entire income for each of these years.

On July 31, 1992 Walter Gross gave each of his three children 124.5 shares of G&J stock, and Patricia Linnemann gave each of her two children 187.5 shares of G&J stock. The gifts to each child represented less than one percent of the corporation's outstanding shares. Walter Gross and his wife Barbara each reported one-half of the asserted value of the gifts to their children on a timely filed Form 709, United States Gift (and Generation Skipping Transfer) Tax Return ("Form 709"). Patricia Linnemann and her husband Calvin did the same with respect to the gifts to their children. In reporting these gifts to the IRS, the Grosses and Linnemanns ("Taxpayers") relied on an appraisal report prepared by Business Valuations, Inc. This report, dated July 22, 1992, valued the G&J stock at $ 5,680 per share as of May 31, 1992. Based upon this report, the Grosses reported a total gift value of $ 2,121,480 and the Linnemanns reported a total value of $ 2,130,000. Upon receiving the report of these gifts, the Commissioner of Internal Revenue ("Commissioner") issued notices of deficiency to Taxpayers based on his valuation of the stock at a much higher amount, $ 11, 738.00. The Commissioner later agreed that the shares had a value of no more than $ 10,910 as of the gift date. Taxpayers challenged the Commissioner's determinations in the United States Tax Court.

At trial, both parties relied on expert testimony to establish the value of the shares of G&J stock. Taxpayers relied upon the Testimony of David O. McCoy and Charles A. Wilhoite. McCoy, a business appraiser, prepared a report valuing the common shares of G&J. He was accepted as an expert witness and his report was accepted into evidence as direct testimony. McCoy also prepared an additional report rebutting the testimony of the Commissioner's lone expert witness. Wilhoite is an appraiser and valuation expert who prepared a second rebuttal report in response to the Commissioner's expert. Wilhoite was accepted as an expert on appraisal and valuation methodology and his report was also accepted into evidence as his direct testimony. The Commissioner called Mukesh Bajaj, Ph.D., as an appraisal expert. Bajaj presented two reports, one valuing minority interests in G&J as of the gift date, and one in rebuttal to McCoy's first report. Bajaj was accepted as an expert witness and his reports were accepted into evidence as his direct testimony.

The experts on either side determined the value of the G&J stock using "income approaches" in which a company's fair market value is determined by calculating the present value of its projected future income. One approach used by both parties was the "discounted future cash flow" approach.[2]

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[2] McCoy's initial report used three separate methods to determine the value of the stock shares: the market price comparison approach, the discounted future free cash-flow method, and valuation by capitalization of earnings. He determined a weighted average value of the results of these three approaches and then applied a discount for the lack of marketability, eventually arriving at a value of $ 5,680 per share.

Experts on both sides also agreed that the value of the shares should be discounted to reflect the fact that, as shares of a closely held S corporation, they are not readily marketable. But two basic disagreements distinguished the experts' calculations of the value of G&J stock.

The first disagreement was whether, under the discounted future cash flow approach, to reduce the corporation's projected future income by deducting hypothetical corporate income taxes even though as an S corporation G&J did not pay income taxes. This process is known as "tax affecting." McCoy testified that in 1992 various professional associations published standards governing the conduct of professional business appraisers and that professional appraisers were ethically bound to follow those standards, citing a publication entitled the Uniform Standards of Professional Appraisal Practice ("USPAP"). This document requires appraisers to be aware of, understand, and correctly employ recognized methods and techniques necessary to produce a credible appraisal (the "standards rule"). McCoy testified that in order to comply with the standards rule, and produce a credible appraisal, it was necessary for professional appraisers to "tax affect" the

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Under the discounted future free cash-flow method, McCoy considered G&J to be an asset capable of producing cash flows to its owners for an infinite number of periods. He then determined the present value of G&J's stock by hypothesizing the amount of available cash for each such period, discounting each amount to reflect the delay in payment and the risk of nonpayment, and then summing the results.

earnings of an S corporation. In order to "tax affect" G&J's stock, McCoy introduced a fictitious tax burden, equal to an assumed corporate tax of 40%, which he then applied to reduce the estimated future income of G&J. Both McCoy and Wilhoite testified that despite some growing controversy surrounding the issue, use of a 40% tax affect was the accepted practice at the time Taxpayers performed the transaction in question.

Bajaj also relied on the discounted free flow cash method to value the G&J stock. But, although he was informed of G&J's S corporation status, Bajaj concluded that using a 0% tax rate was appropriate to determine the future earnings of G&J that would be available for distribution. Thus, in essence, Bajaj did not tax affect the stock at all.

The second disagreement between the experts dealt with the amount of the lack of marketability discount. McCoy examined several studies discussing the lack of marketability inherent in closely held and restricted securities such as G&J stock. He testified that his research reflected that an average lack of marketability discount for shares that would eventually become freely tradable was "30%+" and ultimately found that a discount rate of 35% was required to fully compensate an owner for the lack of marketability of those shares. On behalf of the Commissioner, Bajaj also reviewed the commonly cited published studies examining lack of marketability discounts, dividing them into two groups: those that analyzed sales of restricted stock by firms that also had publicly traded shares, and those that compared the share prices used in several successful initial public offerings ("IPOs"). According to Bajaj, the first category of studies revealed that median discounts ranged from 10%-40%. But he

determined that only about 10%-15% of these discounts could be attributed to a lack of marketability. Bajaj then concluded that the studies regarding the second category of firms was not useful in evaluating discount levels for two reasons. First, he indicated that many of the pre-IPO transactions did not occur at fair market values. Second, Bajaj surmised that referring only to discounts of companies that conducted successful IPOs would create a biased sample that could artificially inflate the discount rate. In the end, Bajaj relied upon his own study in which he conducted an empirical analysis of marketability discounts, considering such factors as G&J's generous dividend policy and its restrictive transfer agreements, the latter of which he considered to be a greater marketability restriction. This study considered 157 transactions that took place from 1980 through 1996, 75 of which took place before July 31, 1992, and 79 of which took place after that date. He concluded that the highest predicted discount for G&J was 12.84%. Based on this study as well as the other studies relied upon by McCoy, Bajaj determined that the lack of marketability discount for G&J shares should be 13%. But when considering other factors unique to G&J, such as the restrictive agreements and the fact that the corporation paid out most of its earnings to its shareholders, he came to a final figure of a 25% lack of marketability discount.

Taxpayers filed a motion *in limine* to exclude Bajaj's testimony regarding both tax affecting and the lack of marketability discount as being based upon unproven methodology. The tax court denied these motions and admitted Bajaj's testimony and reports into evidence. After hearing evidence presented by the experts, the tax court determined that the G&J stock should be discounted using a tax affect of 0% and that the lack of marketability discount

should be 25%. Using these figures the tax court ultimately determined that the G&J stock should be valued at a rate of $ 10,910 per share. Taxpayers now appeal from this order. Specifically, they contest (1) the admissibility of expert testimony by the IRS' expert witness based upon methods which taxpayers claim were scientifically unreliable; and (2) the validity of the court's valuation.

I. ADMISSIBILITY OF EVIDENCE

On appeal, Taxpayers allege that the tax court did not follow proper procedures in admitting certain aspects of Bajaj's testimony on behalf of the Commissioner. For the following reasons we hold that the tax court did not abuse its discretion in admitting this testimony.

A.

The tax court's decision whether to admit expert testimony, as well as its decisions regarding how to determine the reliability of that testimony, are reviewed for an abuse of discretion. *See Kumho Tire Co. v. Carmichael*, 526 U.S. 137, 152, 143 L. Ed. 2d 238, 119 S. Ct. 1167 (1999).

B.

Federal Rule of Evidence 702 governs the admissibility of expert testimony. That Rule provides that "if scientific, technical, or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue, a witness qualified as an expert by knowledge, skill, experience, training, or education, may testify thereto in the form of an opinion or otherwise." Fed. R. Evid. 702.

In *Daubert v. Merrell Dow Pharmaceuticals, Inc.*, 509 U.S. 579, 597, 125 L. Ed. 2d 469, 113 S. Ct. 2786 (1993), the Supreme Court held that Rule 702, along with Rule 104(a) (relevance), confers upon trial judges a special obligation to ensure "that an expert's testimony both rests on a reliable foundation and is relevant to the task at hand. Pertinent evidence based on scientifically valid principles will satisfy those demands."[3]

The *Daubert* Court also suggested several criteria that might assist trial courts in making a preliminary evaluation of expert testimony before admitting it: (1) whether a theory or technique has been or can be tested; (2) whether the technique has been subjected to peer review and publication; (3) the known or potential rate of error; and (4) whether the technique has been accepted by the "relevant scientific community," or "has been able to attract only minimal support within the community." *Daubert*, 509 U.S. at 593-94. Subsequent decisions have further refined the requirements of *Daubert*. The Supreme Court has extended *Daubert* to include any testimony based on "technical" and "other specialized knowledge." *See Kumho Tire Co., Ltd.*, 526 U.S. at 152. We have previously held that the mandates of *Daubert* and *Kumho Tire* also apply to decisions of the United States Tax Court. *See Conti v. Commissioner*, 39 F.3d 658, 662 (6th Cir. 1994).

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[3] To this end, the Court found that "knowledge" as used in Rule 702 means "more than subjective belief or unsupported speculation" and the term "applies to any body of known facts or to any body of ideas inferred from such facts or accepted as truth on good grounds." *Daubert v. Merrell Dow Pharmaceuticals, Inc.*, 509 U.S. 579, 590, 125 L. Ed. 2d 469, 113 S. Ct. 2786 (1993).

The Court has stopped short of turning the *Daubert* test into a straightjacket. Rather, it has insisted that trial courts must enjoy "the same kind of latitude in deciding how to test an expert's reliability, and to decide whether or when special briefing or other proceedings are needed to investigate reliability, as it enjoys when it decides whether or not that expert's relevant testimony is reliable." *Kumho Tire Co., Ltd.*, 526 U.S. at 152. Thus, though helpful, the *Daubert* factors are not dispositive in every case. Instead, the Supreme Court has instructed trial courts to consider the specific factors identified in *Daubert* where they are reasonable measures of the reliability of expert testimony. Furthermore, "whether *Daubert's* specific factors are, or are not, reasonable measures of reliability in a particular case is a matter that the law grants the trial judge broad latitude to determine." 526 U.S. at 139. Nonetheless, this call for broad discretion cannot be interpreted as an invitation for the trial judge "to adopt an excessive level of generality in his gate-keeping inquiry." *See Black v. Food Lion*, 171 F.3d 308, 313 (5th Cir. 1999). With this admonition in mind, we now consider the tax court's basis for accepting Bajaj's testimony in the instant case.

1. Testimony Regarding Tax Affecting G&J's Earnings

The tax court acknowledged that Bajaj's testimony was of a "technical nature" and, therefore, determined that *Daubert* applied in the instant case. But Taxpayers contend that the court abused its discretion by terminating its reliability review of the expert's testimony regarding tax affecting upon determining that his methodology was appropriate. Bajaj testified that under the discounted cash flow method, considering a hypothetical corporate tax rate of 40%

would be improper. Thus, he testified that his valuation of the G&J stock was based upon use of the discounted cash flow approach with a 0% tax affect.

The tax court found that when properly applied, the discounted cash flow method, which was used by both parties, is a reliable tool for financial analysis. Noting that "value is a question of fact," the court found that the "difference in opinions as to value reached by the two expert witnesses, at least to the extent it is attributable to the discounted cash-flow approach, is exclusively the result of differences between them as to the values of certain variables." (J.A. at 186.) Thus, the court concluded that Bajaj used the same discounted cash flow methodology as Taxpayers' experts and his decision not to tax affect G&J's earnings was "not a difference as to methodology." (J.A. at 186). The court determined that a challenge to Bajaj's approach to tax affecting was "nonsensical" and declined to apply any of the other factors suggested in *Daubert*, including determining whether Bajaj's method had not been subjected to peer review. (J.A. at 186.)

We disagree with the tax court's characterization of the respective experts' approaches to tax affecting as a mere difference in variables. There was no spectrum of tax percentages from which the court could have selected. Rather, the choice was either a corporate tax rate of 40% or a rate of 0%, the latter meaning no tax affect at all. But while the tax court's analysis was rather cursory, we do not believe that further evaluation was necessary under the circumstances. Taxpayers argue that Bajaj's use of the discounted cash flow analysis without tax affecting is not supported by testing, peer review, publication, or acceptance by the relevant scientific community. To a large extent, Taxpayers' claim that Bajaj's

testimony was inadmissible hinges upon the correctness of their assertions that tax affecting was a generally accepted practice under the discounted cash flow method as of July 31, 1992. In this respect, we believe that Taxpayers' *Daubert* claim is misguided, for they are attacking the correctness of that ultimate valuation more than the reliability of the expert's methods in deriving the value of the shares of stock. The evidence on the record suggested that as of 1992 there was a growing dispute as to the validity of tax affecting the earnings of closely held corporations. In fact, one of Taxpayers' own experts indicated that if charged with the task of valuing the same stock today, he would have to give further consideration to whether he would tax affect the G&J stock. Thus, we do not believe that using a 0% tax affect in calculating the value of stock under a discounted cash flow methodology is scientifically unreliable. For the same reasons we are undeterred by Taxpayers' claim that the use of a 0% tax affect has not been published or submitted for peer review. As the Court recognized in *Daubert*, "in some instances well-grounded but innovative theories will not have been published. . . . Some propositions, moreover, are too particular, too new, or of too limited interest to be published." *Daubert*, 509 U.S. at 593 (citation omitted). "The fact of publication (or lack thereof) in a peer reviewed journal thus will be a relevant, though not dispositive, consideration in assessing the scientific validity of a particular technique or methodology on which an opinion is premised." *Id.*

Although we could imagine challenges to Bajaj's suitability to deliver testimony on what tax affecting approach buyers and sellers would have utilized in 1992, Taxpayers do not assert those claims here. Thus, we believe that further application of the *Daubert* test was unnecessary as to Bajaj's

testimony regarding tax affecting, and the court properly admitted Bajaj's expert testimony on this issue. We note, however, that this finding of admissibility bears no relation to the weight to be given this evidence in determining the value of the shares of G&J stock.

2. Testimony Regarding the Lack of Marketability Discount

Taxpayers also contest the admissibility of Bajaj's testimony indicating that the lack of marketability discount should be 25%. Taxpayers challenge the reliability of what they term the "novel" methodology Bajaj used in calculating this figure and the tax court's failure to fully analyze these methods using the *Daubert* factors. We disagree with Taxpayers' arguments and instead find that the tax court correctly considered statistics relevant to what a reasonable buyer and seller would have considered as of the valuation date. Bajaj's testimony was based upon his own empirical analysis which included a sample of 157 transactions, 79 of which were announced subsequent to the date on which Taxpayers made the transaction at issue. In their motion *in limine* Taxpayers claimed that the data used by Bajaj was unavailable as of the valuation date and that a willing buyer and seller could therefore not have relied upon such data in negotiating a sale price for G&J stock. The tax court rejected this challenge, finding that it is not improper to consider subsequent events that may shed light upon the circumstances that existed as of the valuation date. We have previously held that "subsequent events may only be considered if they were reasonably known on the date of valuation and also that such could be reasonably contemplated on that date." *Morris v. Commissioner*, 761 F.2d 1195, 1201 (6th Cir. 1985) (citing

Estate of Jephson v. Commissioner, 81 T.C. 999, 1002 (1983) (quoting *Couzens v. Commissioner*, 11 B.T.A. 1040, 1165 (1928)). In *Morris* we held that the tax court did not abuse its discretion in refusing to permit introduction of evidence concerning the state of development on decedent's property eight years after the valuation date. The tax court has interpreted our holding as a rule of relevance. *See Estate of Gilford v. Commissioner*, 88 T.C. 38, 53 (1987).[4] Thus, the tax court has considered relevant subsequent events that took place less than one year from the valuation date due to its relevance. *See id.* Inasmuch as the 79 post-valuation date transactions used in Bajaj's study could have been anticipated, their inclusion in his empirical analysis does not impede the admissibility of his testimony on this issue. Furthermore, the record indicates that Bajaj repeated his analysis using only pre-valuation date data. This re-analysis resulted in an even smaller lack of marketability discount, which would have been less favorable to Taxpayers. Based upon these facts we

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[4] The tax court held:

> In light of the Sixth Circuit's opinion in *Morris v. Commissioner*, we believe that the rule against admission of subsequent events is a rule of relevance. Rule 401, Federal Rules of Evidence, applicable in this Court pursuant to Rule 143, Tax Court Rules of Practice and Procedure, and section 7453, defines relevant evidence as "evidence having any tendency to make the existence of any [fact] that is of consequence to the determination of the action more or less probable than it would be without the evidence."

Estate of Gilford, 88 T.C. 38, 53-54 (1987) (citation omitted).

do not believe that Bajaj's opinion regarding the lack of marketability discount was based upon unsound or irrelevant analysis or data. We therefore hold that the tax court did not abuse its discretion in admitting this testimony.

II. VALUATION OF THE GIFTS

Taxpayers also contend on appeal that even if Bajaj's testimony was admissible, the tax court's ultimate valuation decision was clearly erroneous. Their argument is based upon a challenge to the use of a 0% tax affect and the use of a 25% lack of marketability discount. Although a majority of the factors the tax court used in calculating the valuation amount were proper, I take issue with the court's use of a 0% tax affect and would therefore hold that to the extent the valuation was based upon the use of a 0% tax affect, the court's ultimate finding that the G&J stock was worth $ 10,190 per share was clearly erroneous. However, Judge Daughtrey and Judge Cohn disagree with me on this point, so that our majority holding is that the tax court's use of the 0% tax affect was proper.

A.

The parties dispute the proper standard of review to be utilized by this Court. Generally, we review the tax court's findings of fact for clear error and its application of law *de novo*. *See Friedman v. Commissioner*, 216 F.3d 537, 541 (6th Cir. 2000); *Ekman v. Commissioner*, 184 F.3d 522, 524 (6th Cir. 1999). The Commissioner contends that the determination of "fair market value" of G&J stock is a question of fact and the tax court's determination may be reversed only if it is clearly erroneous. *See Estate of*

Newhouse v. Commissioner, 94 T.C. 193, 217 (1990); *Akers v. Commissioner*, 798 F.2d 894, 897 (6th Cir. 1986) (both holding that determining the value of a gift is an issue of fact and the tax court's factual findings as to fair market value may be reversed only if the determination is clearly erroneous). Yet the question of whether the tax court used the correct standard to determine the fair market value is a legal issue. *See Powers v. Commissioner*, 312 U.S. 259, 260, 85 L. Ed. 817, 61 S. Ct. 509 (1941); *Razavi v. Commissioner*, 74 F.3d 125, 127 (6th Cir. 1996) (holding that the determination of whether the tax court used the correct standard to measure "fair rental value" is a legal issue); *Ruehlmann v. Commissioner*, 418 F.2d 1302, 1304 (6th Cir. 1969) (holding that the criterion to be applied in determining value is a matter of law). It is undisputed that for federal gift tax purposes the fair market value is the price at which the stock would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts. *See United States v. Cartwright*, 411 U.S. 546, 551, 36 L. Ed. 2d 528, 93 S. Ct. 1713 (1973); *Heyen v. United States*, 945 F.2d 359 (10th Cir. 1991); I.R.C. § 2512. This legal standard has come to be known as the "willing buyer/willing seller" standard. In the case at bar, the tax court clearly cited the correct legal standard (the willing buyer/willing seller standard), which was the same standard advocated by Taxpayers. But Taxpayers allege that the court deviated from this standard by not "tax affecting" the G&J stock and by considering post-valuation date data. They therefore argue that the proper standard of review is *de novo* because the issue is a mixed question of law and fact. *See Razavi*, 74 F.3d at 127.

We find that this dispute is not over the proper criteria to be used in determining fair market value, but rather over whether those criteria were properly applied. Essentially, Taxpayers are merely arguing that the tax court erred in its final valuation by failing to tax affect G&J's stock and by finding that the lack of marketability discount should be 25%. These contentions do not challenge the actual standard; rather they reflect a difference in opinion as to the methodologies used to arrive at the valuation amount. "The choice of the appropriate valuation methodology for a particular stock is, in itself, a question of fact." *Estate of Newhouse*, 94 T.C. at 245 (citing *O'Malley v. Ames*, 197 F.2d 256, 258 (8th Cir. 1952); *Riss v. Commissioner*, 56 T.C. 388, 430 (1971), *aff'd sub nom. Commissioner v. Transport Mfg. & Equipment Co.*, 478 F.2d 731 (8th Cir. 1973), *aff'd, cause remanded* 478 F.2d 1160 (8th Cir. 1973)). Thus, we will review the tax court's valuation decision only for clear error.

A finding is clearly erroneous when, although there is evidence to support it, a review of the entire record leaves the reviewing court with the definite and firm conviction that a mistake has been made. *See Commissioner v. Duberstein*, 363 U.S. 278, 291, 4 L. Ed. 2d 1218, 80 S. Ct. 1190 (1959); *Faulconer v. Commissioner*, 748 F.2d 890, 895 (4th Cir.1984). This standard of review requires that we accord great deference to the values established by the tax court, but it does not render us a mere rubber stamp. *See Miami Valley Broad. Corp. v. Commissioner*, 594 F.2d 556, 557 (6th Cir. 1979). This Court can only overturn the tax court's decision if it is "left with a definite and firm conviction that a mistake has been committed." *Anderson v. Bessemer City*, 470 U.S. 564, 573, 84 L. Ed. 2d 518, 105 S. Ct. 1504 (1985) (quoting *United States v. United States Gypsum Co.*, 333 U.S. 364, 92

L. Ed. 746, 68 S. Ct. 525 (1948)). When reviewing for clear error, the court cannot substitute its judgment for that of the tax court but rather must uphold the tax court's account of the evidence if it is plausible in light of the record viewed in its entirety. 470 U.S. at 574. "Where there are two permissible views of the evidence, the fact finder's choice between them cannot be clearly erroneous." *Id.* Thus, where the tax court's findings of fact rest upon credibility determinations, the fact finder's choice must be accorded more deference. Moreover, the Commissioner's determination of a tax deficiency is presumptively correct and the taxpayer has the burden of proving that the determination is erroneous or arbitrary. See *Kearns v. Commissioner*, 979 F.2d 1176, 1178 (6th Cir. 1992) (citing *United States v. Janis*, 428 U.S. 433, 440, 49 L. Ed. 2d 1046, 96 S. Ct. 3021 (1976)); *see also* Tx Ct. R. 142(a).[5]

B.

The Internal Revenue Code imposes a tax on the transfer of property by gift. The valuation of a gift of stock is the fair market value on the date the gift was made. *See* I.R.C. § 25.2512-2(a). Fair market value has been defined as the "price at which the property would change hands between a willing buyer and a willing seller, neither being under any

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[5] Tax Court Rule 142(a) provides that "the burden of proof shall be upon the petitioner, except as otherwise provided by statute or determined by the Court; and except that, in respect of any new matter, increases in deficiency, and affirmative defenses, pleaded in the answer, it shall be upon the respondent." Tx Ct. R. 142(a); I.R.C. § 7453; *see also Friedman v. Commissioner*, 216 F.3d 537, 542 (6th Cir. 2000).

compulsion to buy or sell and both having reasonable knowledge of the relevant facts." Treas. Reg. § 25.2512-1; *see also United States v. Cartwright*, 411 U.S. 546, 551, 36 L. Ed. 2d 528, 93 S. Ct. 1713 (1973); *cf. Razavi*, 74 F.3d at 127 (defining the term "fair rental value" in a similar fashion and by reference to the term "fair market value").

Moreover, the IRS's published regulations indicate that "determination of fair market value, being a question of fact, will depend upon the circumstances in each case . . . [and a] sound evaluation . . .[requires] common sense, informed judgment and reasonableness." *Rev. Rul.* 59-60 § 3.01, 1959-C.B. 237, 238, *modified by Rev. Rul.* 65-193, 1965-2 C.B. 370. Section 4 of *Revenue Ruling* 59-60 provides:

> It is advisable to emphasize that in the valuation of the stock of closely held corporations or the stock of corporations where market quotations are either lacking or too scarce to be recognized, all available financial data, as well as all relevant factors affecting the fair market value, should be considered. The following factors, although not all-inclusive are fundamental and require careful analysis in each case:
>
> (a) The nature of the business and the history of the enterprise from its inception.
>
> (b) The economic outlook in general and the condition and outlook of the specific industry in particular.

> (c) The book value of the stock and the financial condition of the business.
>
> (d) The earning capacity of the company.
>
> (e) The dividend-paying capacity.
>
> (f) Whether or not the enterprise has goodwill or other intangible value.
>
> (g) Sales of the stock and the size of the block of stock to be valued.
>
> (h) The market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter.

Rev. Rul. 59-60 § 4, 1959-1 C.B. 237.

After hearing the evidence on these issues, the tax court found that the fair market value of a share of G&J stock on July 31, 1992 was $ 10,910. In so holding, the court noted that valuation is an issue of fact on which Taxpayers' beared the burden of proof. Taxpayers contend that the tax court lost sight of the willing buyer and willing seller standard. They assert that the tax court made no attempt to discuss or analyze any of the relevant facts which a hypothetical buyer of a minority interest in G&J stock would be legally presumed to know and act upon with respect to two key variables--the decision whether to tax affect G&J's earnings and the extent of the lack of marketability discount.

1. Tax Affecting[6]

Taxpayers contend that a willing buyer in 1992 would have tax affected the stock by 40% in determining a purchase price. Their main argument in support of this contention is that a hypothetical willing buyer in 1992 would be presumed to know that tax affecting earnings was the generally accepted practice of the business appraisal community in valuing a minority interest in S corporations. The Commissioner argues that tax affecting was not a generally accepted business practice at the time. At trial, both parties presented conflicting evidence on this issue. Bajaj testified to that it would be unreasonable to subtract hypothetical corporate income taxes from G&J's projected future income because the corporation did not, in fact pay any taxes. But Taxpayers largely discredited Bajaj's testimony by pointing out that by his own admission he had no first hand knowledge of what willing buyers did in 1992. In fact, Bajaj testified that he had no first hand knowledge as to what the accepted practice among tax appraisers was in 1992 regarding tax affecting S corporation stock. Conversely, both McCoy and Wilhoite testified on behalf of Taxpayers that tax affecting was the approach generally followed in 1992 by the appraisal community in evaluating S corporations. On cross-examination, McCoy did admit that there was a growing controversy in 1992 as to the propriety of the tax affecting. McCoy also agreed that the matter was still being debated as of the time of trial and that if he had to value stock of the G&J corporation as of that time, he would give further

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[6] The opinion expressed in this section, II.B.1, is solely that of Judge Clay, and not the opinion of the majority.

consideration as whether he would use the tax affecting method. But, as Taxpayers note, the fact that there was a growing controversy on the issue does not necessarily mean that the method was not generally relied upon in 1992. McCoy averred that despite a sprinkling of articles questioning tax affecting, it was the recognized practice for appraising S corporations at the time. In fact, McCoy testified that although there may have been other approaches to appraising the stock of S corporations, all that he had seen had tax affected.

Taxpayers attempted to justify use of tax affecting by arguing that although an S corporation does not have to pay property taxes, there are costs or trade-offs in electing S corporation status which tax affecting is intended to address. But the court found that as a "theoretical matter" and "as a matter of economic theory," that tax affecting was inappropriate to offset these concerns. In addition the court found, and the Commissioner now argues, that despite Taxpayers' contention that tax affecting was the recognized practice, it would be imprudent to tax affect the stock of an S corporation absent the existence of circumstances indicating that these trade-offs were at play with respect to G&J. One of these trade-offs was that S corporations sacrifice growth opportunities and capital appreciation in exchange for current income. Through the expert testimony of McCoy and Wilhoite, Taxpayers also claimed that S corporation shareholders were at risk that the corporation might not distribute enough of its income to through dividends to cover the shareholders' tax obligations. They argued that tax affecting is appropriate because an S corporation is "committed" to distributing enough income to its shareholders to cover their tax liabilities and this "imbedded cost" must be

recognized. The tax court rejected the notion that tax affecting was necessary to offset the possibility that G&J might not distribute enough income to cover its shareholder liabilities. The court noted that the evidence on the record indicated that G&J distributes nearly all of its income to the shareholders and found that this fact, combined with G&J's strong growth record made it unlikely that the corporation would be unable to distribute sufficient income to cover shareholder tax liabilities. But in fact, McCoy testified and Bajaj seemed to agree that in 1992, G&J had limited growth opportunities for the next several years. (J.A. at 252, 254.) Absent a strong projected growth pattern, the fact that a corporation distributes nearly all of its income to the shareholders does not guarantee that it will distribute dividends sufficient to cover all tax liabilities while leaving a desirable net profit.

McCoy also indicated that tax affecting was necessary in order to protect against the danger that an S corporation might lose its "S" status. But the tax court found that it was illogical to tax affect an S corporation's income without facts or circumstances that established the likelihood that its S corporation status would be lost. In support of this finding the court noted that G&J's majority shareholders had already signed restrictive agreements that would preempt any transfers that would jeopardize G&J's S corporation status and that there was no indication in the record that they planned to terminate this practice. But these agreements were only designed to protect the S corporation status, which the corporation entered into by written agreement, for at least ten years. The restrictive agreements governed only the transfer of stock. Although they were designed to protect the S corporation status, that status could have been shed absent a transfer of shares. Thus, the restrictive agreements were not

the final authority. Although there is no indication that G&J sought to immediately shed its S corporation status, the period of agreement was to expire soon after the transactions at issue took place. Even if G&J's shareholders had no immediate plans to alter the company's S corporation status, there was no guarantee that the company would retain this status for a significant time beyond the transaction date at issue in this case. It is this prospective period which concerns buyers and sellers of stock insofar as events occurring during that time period have a bearing on the current sale price. Therefore, a willing buyer and seller anticipating the corporation's future earnings and would have to note the fact that G&J's S corporation status was not guaranteed.[7]

Aside from its attempt to distinguish the particular characteristics of G&J, the tax court's opinion focused on its theoretical belief that tax affecting was not an appropriate substitute for certain "difficult to quantify disadvantages" of S corporation status. The court believed that the principle benefit that shareholders of an S corporation expected was reduced taxes and it saw "no reason why that savings ought to be ignored . . . in valuating an S corporation." (J.A. at 192-194.) *Cf. In re Radiology Assocs., Inc. Litig.*, 611 A.2d 485, 495 (Del. Ch. 1991) (holding that ignoring taxes altogether is the only way that the discounted cash flow

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[7] Taxpayers also contended that tax affecting was necessary to compensate for the disadvantages G&J faced as an S corporation in raising capital. But the court dismissed this concern, finding that it was not a proper justification for tax affecting inasmuch as this disadvantage is more appropriately addressed in determining the appropriate "cost of capital." Taxpayers have not attacked this rationale on appeal.

analysis can reflect accurately the value of a company's cash flows to its investors). I recognize that in making this factual determination, the tax court is not bound by the opinion of any expert witness and may accept or reject that testimony in the exercise of its sound judgment. *See Helvering v. Nat'l Grocery Co.*, 304 U.S. 282, 295, 82 L. Ed. 1346, 58 S. Ct. 932 (1938). But I believe that in the instant case the tax court's judgment was less than sound in many respects, for it flies in the face of the evidence on the record.

On appeal Taxpayers assert that tax affecting was an accepted practice because it had been "specifically approved" by the tax court, citing *Maris v. Commissioner*, 1980 *T.C. Memo 444*, 41 T.C.M. (CCH) 127, 138 (1980) and *Hall v. Commissioner*, 1975 T.C. *Memo 141*, 34 T.C.M. (CCH) 648, 667 (1975). Although not specifically holding that tax affecting was an acceptable approach to valuation in every circumstance, in both of these cases the tax court did use after-tax earnings in valuing the stock of S corporations.[8]

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[8] In addition, these cases noted the imprecise nature of valuing such stocks:

> We recognize that the valuation process is not an exact science . . . . Since this unwelcomed onus has been placed on this Court, we have, in the exercise of our 'Solomon-like wisdom,' . . . arrived at our determination of fair market value, as reflected in our ultimate finding of fact, by weighing all of the facts and circumstances contained in the entire record.

Estate of Hall v. Commissioner, 1975 *T.C. Memo 141*, 34 T.C.M. (CCH) 648, 666 (1975) (citation omitted).

But perhaps Taxpayers most persuasive argument is that the IRS itself has implicitly endorsed the policy of tax affecting in valuating stock of S corporations. In support of this claim, Taxpayers point to two internal IRS documents which mention making adjustments for taxes of S corporations. The IRS Valuation Guide for Income, Estate and Gift Taxes: Valuation Training for Appeals Officers states at pages 7-14:

S corporations lend themselves readily to valuation approaches comparable to those used in valuing closely held corporations. You need only adjust the earnings from the business to reflect estimated corporate income taxes that would have been payable had the Subchapter S election not been made.

(J.A. at 864.) In addition, the IRS Examination Technique Handbook provides:

> If you are comparing a Subchapter S corporation to the stock of similar firms that are publicly traded, the net income of the former must be adjusted for income taxes

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Once again we are asked to determine the value of shares of stock in a closely-held corporation, a science which, to use Winston Churchill's words, usually results in a "gross terminal logical inexactitude". Determinations of value of closely held stock involve a melding of numerous objective criteria, prior human experience and personal judgment.

Maris v. Commissioner, 1980 *T.C. Memo 444*, 41 T.C.M. 127, 137 (1980).

> using the corporate tax rates applicable for each year in question, and certain other items, such as salaries. These adjustments will avoid distortions when applying industry ratios such as price to earnings.

(J.A. at 865.) In rebuttal, the Commissioner argues that these documents were intended for internal IRS use only. This much is evident in the express language included on the cover of IRS Valuation Guide, which warns: "This material was designed specifically by the IRS for training purposes only. Under no circumstances should the contents be used or cited as authority for setting or sustaining a technical position." (J.A. at 862.) Indeed, Taxpayers' own expert, McCoy, acknowledged that these documents were intended solely for the use of IRS employees. But McCoy responded to this argument by asserting that it was irrelevant because in the real world professionals still relied on the manuals and, therefore, their clients did, too. The tax court determined that Taxpayer's did not show that they had actually relied on these internal guidelines and therefore failed to show the type of detrimental reliance that would justify estopping the Commissioner from disregarding the tax affecting methodology. But I do not believe that Taxpayers must show that they actually relied on these materials in preparing their tax returns. Rather, the principles stated in these materials bear evidentiary weight in support of the notion that a willing buyer and seller would have used the same tax affecting approaches stated therein in valuating shares of G&J stock. Although I do not agree with Taxpayers' contention that the IRS is somehow estopped from now disclaiming tax affecting as a recognized practice, I recognize that these documents

reflect a certain acceptance of tax affecting as a valid method of valuation.

The notion that willing buyers and sellers would have used tax affecting under the discounted cash flow methodology is further supported by the fact that the IRS had previously approved 1988 taxes paid by Taxpayers based on gifts of G&J stocks valued at $ 3,900 per share -- a sum determined by tax affecting G&J stock. Taxpayers assert that the Commissioner's review and approval of these previous returns entitles them to rely upon tax affecting at a later date, claiming that the Commissioner somehow acted "retroactively" to their detriment. In support of this proposition they cite *E.W. Bliss Co. v. United States*, 224 F. Supp. 374 (N.D. Ohio 1963), *aff'd* 351 F.2d 449 (6th Cir. 1965), in which the court held that the Commissioner cannot act retroactively in a particular case where his own regulations are "broad enough to allow a taxpayer's method as one in accordance with generally accepted accounting principles or best accounting practices and one which was consistently followed." 224 F. Supp. at 384. In *Bliss*, the court stated:

> [if a taxpayer's] method of valuing its inventory of work in process is substantially in accord with the regulations, great weight must be given to its long record of consistent application of the same method . . . The Government's most vigorous objection to the taxpayer's method of valuing its inventory is to the latter's allowance of a normal margin of profit. The Government asserts that the allowance of a normal profit in evaluating

> inventories is not recognized by the American Accountants Association or by the Chartered Accountants of England was Wales. Such an allowance, however, is recognized by the Commissioner of Internal Revenue in Regulation 29.22(C)-8 as being applicable to retail merchants and also has the approval of the American Institute of Certified Public Accountants.

224 F. Supp. at 383-84 (emphasis added). I acknowledge that the facts of the instant case do not reflect numerous returns using tax affecting. Nonetheless, I believe that given the amount of time since the 1988 tax returns, the Commissioner's decision not to allow tax affecting in the returns at issue in this case brings Taxpayers within the aegis of *E.W. Bliss*. Furthermore, although in the instant case the Commissioner had not adopted a specific regulation or policy (such as the allowance regulation in *E.W. Bliss*) that specifically approves tax affecting, the agency's regulations are broad enough to permit the practice and definitely do not ban it outright. *See* Rev. Ruling 59-60 (suggesting reliance upon a wide variety of factors in appraising the value of closely held corporations). Moreover, as I have already discussed, the agency's internal directives seem to permit the practice of tax affecting.

Taxpayers also contend that the Commissioner should not have discretion to treat taxpayers in a manifestly unfair and inequitable manner, especially given the fact that the IRS has not adopted uniform rules or regulations banning tax affecting S corporations. Taxpayers cite *Righter v. United States*, 439 F.2d 1204, 194 Ct. Cl. 400 (Ct. Cl. 1971) which

stands for the proposition that the IRS should not treat parties who are similarly situated in a different manner. In that case, the court held that in determining the value of certain stock held by an estate the IRS's valuations of "other estates, involving the same stock" were probative for valuation of the taxpayer's estate. *Righter*, 439 F.2d at 1212-13. In the instant case we are not confronted with two different parties, but rather the same parties. But we are dealing with two different tax returns, both of which tax affected G&J stock but only one of which was approved by the Commissioner. Thus, I do not believe that this case presents a situation so different from *Righter* as to require a different result. The Commissioner argues that no general rule of law exists that could permit a taxpayer to avoid paying a tax rightfully due by showing that he had escaped his obligation in the past. This much is true, but a principle of law does require that the IRS establish practices and procedures that are consistent and predictable, not subject to the whim of the Commissioner. *See Estate of Bright v. United States*, 658 F.2d 999, 1006 (5th Cir. 1981) (rejecting the proposed practice of family attribution based upon "the important policy that the law should be stable and predictable" and noting that such a policy "is especially important in the tax laws, because there is widespread reliance by taxpayers upon established tax principles in planning their affairs") (citing *Estate of Hattie L. McNary v. Commissioner of Internal Revenue*, 47 T.C. 467 (1967)).

I must recognize that we are merely determining those factors that hypothetical parties to a sale of G&J stock would have considered as of the gift date. In this regard, I believe that past practices, which the IRS had not deemed to create a deficiency, are demonstrative of the idea that such hypothetical actors would have considered tax affecting G&J

stock. This fact in conjunction with the testimony of the experts informs my conclusion that the court's decision to use a 0% tax affect in deriving the value of G&J stock was implausible.

2. Lack of Marketability Discount

With respect to the lack of marketability discount, Taxpayers contend that the court erred in using post-valuation date statistics that a reasonable buyer in 1992 could not have relied upon. We disagree and instead find that the tax court correctly considered statistics relevant to what a reasonable buyer and seller would have done in 1992.

At trial, both sets of experts agreed that because the shares of a closely held S corporation such as G&J are not readily marketable, Taxpayers were entitled to a lack of marketability discount. Taxpayer's expert McCoy cited the lack of marketability discounts listed in three independent studies. Using the average of the lack of marketability discounts in the three studies, he asserted that the "minimum" lack of marketability discount for valuating G&J stock was 30 to 35%. He also listed what he called "risk premiums" and "risk reductions" that were particular to G&J stock to account for this figure. One of these "risk premiums" was the fact that under the shareholders' restrictive agreement, a G&J shareholder could sell his stock to someone outside of the family groups only if he got someone from the other family group to offer the same number of shares to the outside buyer

such that the two family groups could maintain equal ownership.[9]

Taxpayers claim that in arriving at the 35% lack of marketability figure, McCoy relied partly upon studies that have been generally accepted by the appraisal profession and partly upon an intuitive and necessarily subjective weighting of company-specific facts, one of which was that the restrictive agreements signed by the majority shareholders required balanced ownership of G&J stock between the two family groups. But McCoy acknowledged that he had not actually read many of the studies upon which he relied in coming up with the thirty to 50% figure. Rather, he merely relied upon summaries of those studies. McCoy also admitted that the studies showed a wide range of discounts and that several of them showed correlations between certain characteristics of the firms, such as quantity of sales, and the amount of the lack of marketability discount.

In his analysis, Bajaj analyzed the same commonly published studies of lack of marketability discounts that McCoy cited. But Bajaj noted some problems with these

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[9] On cross-examination, however, McCoy admitted that the restrictive agreements between the family groups did not contain any limitation requiring balanced ownership. Rather, the Gross/Linnemann and Jarson family groups each had their own agreements restricting the transfer of stock outside of the respective family groups. Although functionally, the force of both agreements would maintain the status quo of each family group owning 50 of the outstanding shares of G&J stock, they did not explicitly require that the 50 balance be maintained.

studies. He therefore conducted his own independent analysis and, rather than simply applying the average discounts listed in those studies, analyzed G&J specifically to determine the proper lack of marketability discount. Although 79 of the sample transactions used in the study occurred after the valuation date, Bajaj concluded that using post-1992 data was appropriate because there is no reason to believe that the underlying economics would have changed after the valuation date. The tax court found that reliance on such figures was appropriate because they demonstrated more accurately than the flawed earlier studies what willing buyers and willing sellers were actually doing in 1992. On appeal, Taxpayers contend that even if the prior studies were indeed flawed, that willing buyers and sellers still relied upon them and they could not have relied on Bajaj's figures because they did not exist as of July 31, 1992. But Taxpayers fail to note that Bajaj repeated his analysis using only pre-valuation date data. This re-analysis resulted in an even smaller lack of marketability discount, which would have been less favorable to Taxpayers. Furthermore, Taxpayers do not reconcile their position with this Court's acknowledgment that subsequent events may be considered if they could be reasonably contemplated on the valuation date. *See Morris v. Commissioner*, 761 F.2d at 1201.

Admittedly, there is a fair amount of conflicting evidence on this issue. But we note that the tax court's determination hinged in large part upon the credence it gave to the testimony of the respective witnesses. Indeed, the court indicated that it found Bajaj's testimony regarding the lack of marketability discount "thorough and more persuasive" than McCoy's. (J.A. at 196.) As the Eighth Circuit recognized, the tax court "does not have to accept 'in toto, in part' or at all"

opinions of value provided by experts," *Estate of Ford v. Commissioner*, 53 F.3d 924, 927 (8th Cir. 1995) (quoting *Palmer v. Commissioner*, 523 F.2d 1308, 1310 (8th Cir. 1975)). This holding reiterates the fact that the tax court is in the best position to make factual determinations as to the fair market value of stocks. We cannot conclude that the tax court erred in finding that Bajaj's indicated what a willing buyer and seller would have contemplated on July 31, 1992. Aside from questioning the admissibility of this testimony, a claim which we have already rejected, Taxpayers have done nothing to show that Bajaj's opinion as to the amount of the lack of marketability discount was in error. In this regard, we find that the tax court's application of a 25% lack-of marketability discount was not clearly erroneous.

III.

In considering the parties' arguments on appeal, I would find that the record does not support the tax court's ultimate valuation of G&J stock at $ 10,910 per share. The tax court derived this figure by considering multiple factors, only two of which Taxpayers contested in this case -- tax affecting and the lack of marketability discount. Despite the finding that the testimony of the Commissioner's expert was admissible with respect to both of these factors, this testimony was insufficient to support the court's valuation decision. Although I would conclude that the tax court's decision to apply a 25% lack of marketability discount was supported by facts on the record, I also am of the belief that the court's decision to tax affect the stock by 0% did not accurately reflect the fair market value of G&J stock as determined under the willing buyer/willing seller standard. Instead of relying upon real-world evidence, the court reverted to its

own perception of the proper approach to tax affecting, thereby deviating from the time-sensitive willing buyer/willing seller standard. I therefore would hold that to the extent it was based upon the use of a 0% tax affect the court's ultimate valuation of $ 10,910 was clearly erroneous. However, as explained in Judge Cohn's opinion, neither he nor Judge Daughtrey believe that the tax court erred in utilizing the 0% tax affect in order to determine the stock's valuation.

CONCLUSION

For the aforementioned reasons, I would reverse the valuation decision of the tax court and remand for revaluation in a manner not inconsistent with my opinion; however, Judge Cohn's opinion constitutes the holding of the court in this case; that is, that the tax court's decision is **AFFIRMED**.

CONCUR BY

Avern Cohn (In Part)

DISSENT BY

Avern Cohn (In Part)

DISSENT

COHN, Senior District Judge.

I. Introduction

I concur with Parts I., II. A., and II.B.2 of the lead

opinion. However, because I believe that the Tax Court did not clearly err in concluding that it was appropriate not to tax affect the stock in order to determine its fair market value, I respectively disagree with Part II.B.1 and therefore find that the decision of the Tax Court must be affirmed on this ground.

II. Analysis

A.

Taxpayers essentially argue that the valuations presented by their experts are more credible than Dr. Bajaj's valuation and the Tax Court erred in accepting Dr. Bajaj's valuation. This appeal really presents a battle of the experts on the question of how the stock of a closely held S Corporation, such as G&J, should be valued.

Section 2501 of the Internal Revenue Code imposes a gift tax "on the transfer of property by gift during [the] calendar year by any individual." 26 U.S.C. § 2501(a)(1) (1988). Section 2512(a) addresses the valuation of gifts, stating, "if the gift is made in property, the value thereof at the date of the gift shall be considered the amount of the gift." 26 U.S.C. § 2512(a) (1988). In interpreting this provision, section 25.2512-1 of the Treasury Regulations on gift tax provides, "the value of the property is the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts." 26 C.F.R. § 25.2512-1 (1992). This is known as the willing buyer willing seller rule.

Where, as here, the gift is stock, its value for gift tax purposes is the fair market value of the stock on the date of the transfer, and "all relevant facts and elements of value as of the time of the gift shall be considered." 26 C.F.R. § 25.2512-1 (1992). For publicly traded stock, valuation can generally be based on market selling prices. *See* 26 C.F.R. § 25.2512-2(b) (1992). For closely held corporations, such as G&J, for which there is no public trading market, valuation of stock is therefore based on of a variety of factors.

Revenue Ruling 59-60 outlines the general approach, methods and factors to be considered in valuing the shares of stock of closely held corporations for estate and gift tax purposes, stating:

> 3.01. A determination of fair market value, being a question of fact, will depend upon the circumstances in each case. No formula can be devised that will be generally applicable to the multitude of different valuation issues arising in estate and gift tax cases.... A sound valuation will be based upon all the relevant facts, but the elements of common sense, informed judgment and reasonableness must enter into the process of weighing those facts and determining their aggregate significance.

Rev. Rul. 59-60, 1959-1 C.B. 237, 238.

Valuing closely held stock incorporates a number of alternative methods of valuation, and the appellate courts have afforded the tax court broad discretion in determining what method of valuation most fairly represents the fair market

value of the stock in light of the facts presented at trial. *See Palmer v. Comm'r of Internal Rev.*, 523 F.2d 1308 (8th Cir. 1975). Moreover, "complex factual inquiries such as valuation require the trial judge to evaluate a number of facts: whether an expert appraiser's experience and testimony entitle his opinion to more or less weight; whether an alleged comparable sale fairly approximates the subject property's market value; and the overall cogency of each expert's analysis." *Ebben v. Comm'r* , 783 F.2d 906, 909 (9th Cir. 1986).

B.

1. Dr. Bajaj opined that tax affecting G&J's earnings was inappropriate because G&J does not pay corporate taxes, and given this closely held status and restriction on stock transfers, there was no reason to believe that G&J would not continue as an S Corporation. Dr. Bajaj also reasoned that based on G&J's past practice of distributing nearly all of its income to its shareholders, a zero percent corporate tax rate was appropriate to make in determining G&J's corporate earnings available for distribution. Moreover, Dr. Bajaj emphasized that because an S Corporation receives a tax benefit (no corporate taxes), such a benefit should not be ignored in valuing G&J's stock.

McCoy, on the other hand, opined that applying a fictitious 40% tax rate to reduce G&J's earnings was appropriate. McCoy testified that tax affecting is an accepted practice in valuation of an S Corporation. McCoy explained that the trade-offs shareholders incur as a result of being part of an S Corporation must be accounted for, which is accomplished by tax affecting. McCoy indicated that if an S

Corporation distributes less than all of its income to its shareholders, the distributions might not cover the shareholders' tax obligations. Thus, tax affecting offsets that potential burden.

McCoy also cited to two internal documents of the Internal Revenue Service that apparently says tax affecting an S Corporation's earnings for valuation: a valuation guide for income, estate, and gift taxes (the guide), an examination technique handbook for estate tax examiners (the handbook) (collectively, the IRS materials). The guide states in part:

[S] corporations are treated similar to partnerships for tax purposes. S Corporations lend themselves readily to valuation approaches comparable to those used in valuing closely held corporations. You need only to adjust the earnings from the business to reflect estimated corporate income taxes that would have been payable had the Subchapter S election not been made.

The handbook provides in part:

If you are comparing a Subchapter S Corporation to the stock of similar firms that are publicly traded, the net income of the former must be adjusted for income taxes using that corporate tax rates applicable for each year in question, and certain other items, such as salaries. These adjustments will avoid distortions when applying industry ratios such as price to earnings.

2. The Tax Court found that applying a 0% corporate tax rate, effectively not tax affecting, G&J's stock was appropriate. The Tax Court discussed the competing

expert's opinions, paying particular attention to Taxpayers' experts and examined their opinions in light of the facts of the case. The Tax Court first noted that the IRS materials quoted above "neither require tax affecting nor lay[] the basis for a claim of detrimental reliance" inasmuch as Taxpayers "failed to prove that they relied on [the IRS materials] in any way." (JA at 190-91). The Tax Court also rejected the Taxpayers' justification for tax affecting that it addresses the possibility that an S corporation may distribute less than all of its income, which would not be sufficient to cover the shareholder's tax obligations. The Tax Court explained that "G&J had a strong growth record and a history of making cash distributions to shareholders that nearly equaled its income [and] . . . it would not be reasonable to assume G&J would not continue this practice." (JA at 191). The Tax Court also rejected the argument that G&J might lose its Subchapter S status as a basis for tax affecting its stock because there was not sufficient evidence that G&J's status would be lost. Overall, the Tax Court was not convinced that tax affecting was an appropriate valuation method for valuing G&J's stock. The Tax Court explained that "the principle benefit that shareholders expect from an S corporation election is a reduction in the total tax burden imposed on the enterprise. The owners expect to save money, and we see no reason why that savings ought to be ignored as a matter of course in valuing the S corporation." (JA at 194).

C.

1. As noted in the lead opinion, Dr. Bajaj and McCoy disagreed over whether tax affecting was a generally accepted practice in 1992. Indeed, McCoy's testimony, when carefully reviewed, reveals that even he was not certain

whether tax affecting was generally accepted, acknowledged some disagreement on this point, and was equivocal on whether he would continue to tax affect. The lead opinion, however, finds that the Tax Court clearly erred in its decision to not tax affect G&J's stock because willing buyers and willing sellers would have tax affected the stock in 1992. While I do not necessarily disagree with framing the issue in this manner, I do disagree with the way in which the lead opinion analyzes the issue. The lead opinion accuses the Tax Court of focusing on "its theoretical belief that tax affecting was not appropriate." The lead opinion also states that "the tax court's judgment was less than sound" and "flies in the face of the evidence on the record." I read the record differently. The Tax Court was faced with the opinions of competing valuation experts and accepted one over the other. While the Tax Court did not explicitly state that it found Dr. Bajaj's valuation more "credible," the Tax Court certainly found as much when it declined to tax affect G&J's stock. Moreover, while the Tax Court did state that it did not believe that tax affecting was "appropriate as a matter of economic theory," (JA at 194), this statement was made in the context of deciding whether or not to tax affect, and reflects the Tax Court's opinion that McCoy's valuation including tax affecting was not appropriate. Given the disagreement on the propriety of tax affecting, and applying the proper standard of review, I do not believe that the Tax Court clearly erred in this regard.

2. The lead opinion appears to emphasize the apparent unfairness to Taxpayers if G&J's stock is not tax affected and accuses the IRS and the Tax Court of being "hypocritical" and "arbitrary" in their valuations. Unfairness, however, is not the issue and even if it was, the Taxpayers

were not unfairly treated by not tax affecting G&J's stock. First, the lead opinion disagrees with the Tax Court's finding that the IRS policy manuals do not establish that tax affecting is a necessary part of valuing an S Corporation. I do not believe that this finding is clearly erroneous and in fact is well supported in the record. Not only do the statements in the IRS manuals fail to affirmatively advocate tax affecting for all S Corporation valuation, both the guide and handbook provide that are not to be relied upon as binding authority, thus even if Taxpayers relied on these materials, their reliance was not justified.

Moreover, focusing solely on the perceived unfairness to the Taxpayers is improper because the willing buyer willing seller rule does not permit a determination of fair market value based solely on the price-lowering desires of the willing buyer. *See Mandelbaum v. Comm'r , T.C. Memo 1995-255, 1995 Tax Ct. Memo LEXIS 256*, 69 T.C.M. (CCH) 2852, 2866 (1995), *aff'd without published opinion*, 91 F.3d 124 (3d Cir. 1996)("ignoring the views of a willing seller is contrary to the willing buyer/willing seller test"). Thus, determining fair market value also requires consideration of the standpoint of the willing seller.

Secondly, the lead opinion discusses the possibility of G&J losing its Subchapter S status, concluding that "a willing buyer and seller anticipating the corporation's future earnings would have to note the fact that G&J's S corporation status was not guaranteed." To the extent that the lead opinion finds that G&J's Subchapter S status "was not guaranteed," this conclusion appears to contradict the Tax Court's factual finding that "we do not however, think it is reasonable to tax affect an S corporation's projected earnings with an

undiscounted corporate tax rate without facts or circumstances sufficient to establish the likelihood that the election would be lost." (JA at 192). The lead opinion's conclusion that willing buyers and willing sellers might consider that G&J would lose its Subchapter S status is contrary to the evidence of record at the time the gift was made and reflects its own independent opinion of what willing buyers and sellers would consider when valuing G&J's stock.

The lead opinion also criticizes the Tax Court's decision regarding tax affecting because prior decisions permitted tax affecting, and because the IRS accepted prior returns of the Taxpayers which contained valuations that were tax affected. The lead opinion relies on *E.W. Bliss Co. v. United States*, 224 F. Supp. 374 (N.D. Ohio 1963), *aff'd* 351 F.2d 449 (6th Cir. 1965) to support its conclusion that the IRS acted arbitrarily in refusing to accept the returns at issue. *Bliss*, however, is inapposite. In *Bliss*, the district court held that the "Commissioner is without authority to act retroactively in a particular case where his own regulations are broad enough to allow the taxpayer's method as one in accordance with generally accepted accounting principles or best accounting practices and one which was consistently followed." *224 F. Supp. at 384.* First of all, as noted above, there was disagreement among the experts as to whether tax affecting was generally accepted. Second, *Bliss* involved an appeal from a decision of the Commissioner to the district court, not an appeal from a decision of the Tax Court. Thus, the district court presumably had more latitude in reviewing the Commissioner's decision to make the determination that the Commissioner acted arbitrarily in that case.

Most significantly, however, as the Commissioner points out, the Commissioner is not precluded from correcting an error. *See Sirbo Holdings, Inc. v. Commissioner*, 509 F.2d 1220, 1222 (2d Cir. 1975); *Wagner v. United States*, 181 Ct. Cl. 807, 387 F.2d 966, 968 (Ct. Cl. 1967); *Kehaya v. United States*, 174 Ct. Cl. 74, 355 F.2d 639, 641 (Ct. Cl. 1966), *Ward v. Comm'r*, 240 F.2d 184 (6th Cir. 1957). Thus, the fact that tax affecting may have been approved in other cases, and was even approved in prior returns filed by the Taxpayers, does not, and should not, preclude a different result in another case, particularly where there is disagreement over whether to tax affect in determining the value of stock in the first place.

III. Conclusion

Reviewing the conflicting experts' opinions, it appears that Dr. Bajaj's valuation was from an academic perspective, and he clearly took a scholarly approach to the valuation issue. McCoy's valuation, on the other hand, was from the perspective of a business professional, who has performed numerous valuations in his professional career. This distinction is observed not to diminish McCoy's expertise or elevate Dr. Bajaj's, but simply to point out the different ways the experts approached the valuation question to the facts at hand. Ultimately, the Tax Court found that Dr. Bajaj's method was the better reasoned one under the facts and circumstances of the case. I cannot say this was clear error.

The Taxpayers spend a good deal of time arguing that willing buyers would not know Dr. Bajaj's valuation techniques, and that Dr. Bajaj used data available after the date of the gift, and therefore the Tax Court erred in applying

the willing buyer-willing seller rule. This argument is poorly conceived. First, the Tax Court is not prohibited from considering post-valuation data if relevant to shed light on facts existing on the date of the valuation. *See Estate of Gilford v. Comm'r of Internal Rev.*, 88 T.C. 38, 52-53 (1987). Second, the purpose of valuation is to determine what a willing buyer would pay, and what a willing seller would accept, for the stock on the date of the valuation; it is not to determine what methodology the willing buyer would apply. The willing buyer-willing seller rule presupposes that the price will be the fair market value. Valuation, through the use of expert methodology, is the means, not the end, to application of the willing buyer willing seller rule.

Overall, the entire valuation process is a fiction - the purpose of which is to determine the price that the stock would change hands from a willing buyer and a willing seller. However, a court is not required to presume hypothetical, unlikely, or unreasonable facts in determining fair market value. *See Estate of Watts*, 823 F.2d 483, 487 n.2 (11th Cir. 1987). Valuation is a fact specific task exercise; tax affecting is but one tool in accomplishing that task. The goal of valuation is to create a fictional sale at the time the gift was made, taking into account the facts and circumstances of the particular transaction. The Tax Court did that and determined that tax affecting was not appropriate in this case. I do not find its conclusions clearly erroneous.

APPENDIX C

UNITED STATES TAX COURT

No. 4460-97; No. 4469-97

[Filed July 29, 1999]

WALTER L. GROSS, JR., AND BARBARA H. GROSS,
Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent;

CALVIN C. LINNEMANN AND PATRICIA G. LINNEMANN,
Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent

JUDGES:
Halpern, James S.

Ps made gifts to their children of shares in S corporation, which, annually, distributed substantially all of its income. R determined gift tax deficiencies based on adjustments increasing the fair market value of the shares. Principal differences between the parties are (1) whether to "tax affect" corporation's earnings in determining discounted cashflow, (2) the discount for lack of marketability, and (3) the cost of equity.

Held: Value of shares determined; marketability discount and cost of equity determined; tax affecting inappropriate under facts presented.

MEMORANDUM FINDINGS OF FACT AND OPINION

HALPERN, JUDGE: These cases have been consolidated for trial, briefing, and opinion. By notices of deficiency dated December 16, 1996, respondent determined deficiencies in Federal gift taxes as follows:

Docket Number	Petitioner	Year	Deficiency
1460-97	Walter L. Gross, Jr.	1992	$ 584,139
1460-97	Barbara H. Gross	1992	584,140
1469-97	Calvin C. Linnemann	1992	581,605
1469-97	Patricia G. Linnemann	1992	582,807

Unless otherwise indicated, all section references are to the Internal Revenue Code in effect for the years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

The common question presented by these consolidated cases is the July 31, 1992, fair market value of certain shares of corporate stock transferred by gift by petitioners Walter L. Gross, Jr. (Walter Gross), and Patricia G. Linnemann (Patricia Linnemann) to their respective children. Petitioners Barbara H. Gross (Barbara Gross) and Calvin C. Linnemann (Calvin Linnemann), the wife and husband of Walter Gross and Patricia Linnemann, respectively, are petitioners because they and their respective spouses consented to having the gifts made by each spouse considered for Federal gift tax purposes as having been made one-half by each spouse. Respondent initially determined that each share of stock in question had a value of $ 11,738, but now concedes that each such share has a value of no more than $ 10,910. Petitioners based their gift tax liabilities on a value of $ 5,680, which they maintain is the correct value.

FINDINGS OF FACT

Introduction

Some of the facts have been stipulated and are so found. The stipulation of facts, with accompanying exhibits, is incorporated herein by this reference. At the time of the filing of the petitions, all of the petitioners resided in Cincinnati, Ohio.

G&J Pepsi-Cola Bottlers, Inc.

The shares of stock in question are shares of G&J Pepsi- Cola Bottlers, Inc. (G&J), an Ohio corporation formed in 1969. The business operations of G&J can be traced to a business conducted by a partnership formed in the 1920s

between two married couples, Isaac N. and Esther M. Jarson and Walter L. and Nell R. Gross (the founders). By 1992 (the year of the gifts here in question), the founders had died, and ownership of G&J had devolved to certain relatives of the founders, viz, the Gross family group (which included members of the Linnemann family) and the Jarson family group. In 1992, directly and through voting trusts, each family group owned 50 percent of the outstanding shares of stock of G&J.

In 1982, G&J elected to be taxed as a small business corporation (an S corporation), within the meaning of section 1371 of the Internal Revenue Code of 1954. By agreement dated November 1, 1982 (the S corporation agreement), the shareholders of G&J agreed to maintain G&J's status as an S corporation for at least 10 years. G&J, in fact, maintained its S corporation status through July 31, 1992, at which time there were no plans to change its S corporation status. Further, an agreement restricting the transfer of the G&J shares by and among the members of the Gross family group (the Gross family restrictive transfer agreement), dated October 29, 1982, also remained in effect as of July 31, 1992.[1] The Gross family restrictive transfer agreement contained express provisions to prevent termination of G&J's S corporation status. As of July 31, 1992, G&J had issued an outstanding 19,680 shares of common stock without par value.

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[1] There was a similar restrictive transfer agreement by and among the members of the Jarson family group holding shares of G&J dated Apr. 1, 1983, which also remained in effect as of July 31, 1992.

In 1992, G&J's top management positions and voting control were largely in the hands of the senior members of the Gross and Jarson family groups. The shareholders of G&J got along well, and they did not allow differences in their business philosophies to interfere with the successful operation of the corporation. None of G&J's shareholders was interested in selling his or her shares.

In 1992, G&J bottled and distributed various soft drinks, including Seven-Up, Dr. Pepper, and five variations of Pepsi- Cola. Through franchise agreements with PepsiCo, Dr. Pepper, and Seven-Up, G&J had the exclusive right to bottle and distribute the various soft drinks it produced within several geographic territories. G&J was a well-managed company in 1992. It was the third-largest independent Pepsi-Cola bottler. G&J owned most of the real estate associated with its plants and warehouses. It owned in excess of 800 vehicles, including tractors, trucks, and trailers. Additionally, G&J owned about 11,400 soft drink vending machines. G&J sold the soft drinks it produced to supermarkets, convenience stores, mass merchandisers, gas mini-marts, drugstores, vending companies, restaurants, bars, lunch counters, and concessions. In 1992, it had approximately 24,000 customers.

From 1988 through 1992 there were steady increases in G&J's operating income, total income, and distributions to shareholders. During that period, distributions to shareholders nearly equaled the company's entire income, as shown below:

Fiscal Year Ended	Operating Income	Other Income	Total Income	Shareholder Distributions
1988	$ 15,680,903	$2,050,232	$17,731,135	$ 17,778,483
1989	18,150,034	1,329,796	19,479,830	19,458,148
1990	21,623,537	2,323,068	23,946,605	24,032,651
1991	23,796,119	542,321	24,338,440	24,126,041
1992	23,258,506	4,327,367	27,585,873	28,188,889

Petitioners' Gifts

On July 31, 1992, Walter Gross made a gift of 124.5 shares of common stock in G&J to each of his three children (together, the Walter Gross gifts). Each of the Walter Gross gifts represented 0.63 percent of the issued and outstanding shares of G&J. Walter and Barbara Gross (the Grosses) each reported one- half of the amount they determined to be the value of the Walter Gross gifts on a timely filed Form 709, United States Gift (and Generation Skipping Transfer) Tax Return (Form 709). In determining (and reporting) the value of the Walter Gross gifts, the Grosses relied on an appraisal report prepared by Business Valuations, Inc. (the Business Valuations report and Business Valuations, respectively), dated July 22, 1992, valuing shares of G&J's common stock as of May 31, 1992, at $ 5,680 a share. Since the Grosses used a value of $ 5,680 a share, the total reported value of the Walter Gross gifts was $ 2,121,480.

On July 31, 1992, Patricia Linnemann made a gift of 187.5 shares of common stock in G&J to each of her two children (the Patricia Linnemann gifts). Each of the Patricia

Linnemann gifts represented 0.95 percent of the issued and outstanding shares in G&J. Patricia and Calvin Linnemann (the Linnemanns) each reported one-half of the amount they determined to be the value of the Linnemann gifts on a timely filed Form 709. In determining (and reporting) the values of the Patricia Linnemann gifts, the Linnemanns also relied on the Business Valuations report. The total reported value of the Patricia Linnemann gifts was $ 2,130,000.

ULTIMATE FINDING OF FACT

On July 31, 1992, the fair market value of a share of stock of G&J representative of the shares constituting both the Walter Gross and Patricia Linnemann gifts was $ 10,910.

OPINION

I. Introduction

On July 31, 1992, Walter Gross and Patricia Linnemann made gifts to their respective children of shares of stock in a corporation, G&J Pepsi-Cola Bottlers, Inc. (G&J). Walter Gross and Patricia Linnemann are members of a family group (the Gross family group) that, in 1992, owned 50 percent of the outstanding shares of stock of G&J. Each child received a number of shares of stock in G&J constituting less than a 1-percent interest in the corporation. The parties disagree as to the fair market value (value) of those gifts. The parties have assumed that each of the shares of stock in question (a G&J share) had the same value, but have expressed their disagreement over that value. Petitioners argue that, on July 31, 1992 (the gift date), the value of a

G&J share was $ 5,680; respondent argues that it was $ 10,910.

II. Code and Regulations

Section 2501 imposes a tax for each calendar year on the transfer of property by gift during such calendar year by individuals. Section 2512 provides that "[i]f the gift is made in property, the value thereof at the date of the gift shall be considered the amount of the gift." The standard for determining the value of a gift for purposes of the gift tax is fair market value, i.e., the price at which the property would change hands between a willing buyer and seller, neither being under any compulsion to buy or sell, and both having knowledge of relevant facts. See *United States v. Cartwright,* 411 U.S. 546, 551, 36 L. Ed. 2d 528, 93 S. Ct. 1713 (1973); sec. 25.2512-1, Gift Tax Regs. Valuation is an issue of fact, see, e.g., *Estate of Newhouse v. Commissioner*, 94 T.C. 193, 217 (1990), and petitioners bear the burden of proof, Rule 142(a). We have found that the fair market value of a G&J share was $ 10,910 on the gift date. We shall explain our reasons for that finding.

III. Arguments of the Parties

A. Reliance on Expert Testimony

Both parties rely on expert testimony to establish the value of a G&J share. Petitioners rely on the expert testimony of David O. McCoy, a business appraiser, who prepared a report valuing the common shares of G&J. Mr. McCoy was accepted as an expert appraisal witness by the Court, and his report was accepted into evidence as his direct testimony. Mr.

McCoy also prepared a report in rebuttal to respondent's expert witness, which report was accepted into evidence as additional direct testimony. Petitioners also called Charles A. Wilhoite, an appraiser and valuation expert, who prepared a second report in rebuttal to respondent's expert witness. Mr. Wilhoite was accepted as an expert on appraisal and valuation methodology by the Court, and his report was accepted into evidence as his direct testimony. Respondent called Mukesh Bajaj, Ph.D., an appraisal expert, who prepared two reports, one valuing minority interests in G&J as of the gift date, and one in rebuttal to Mr. McCoy's first report. Dr. Bajaj was accepted as an expert appraisal witness by the Court, and his reports were accepted into evidence as his direct testimony.

The principal disagreements among the parties' expert witnesses are: (1) whether it is appropriate to tax affect G&J's earnings in determining the value of a G&J share, (2) the lack of marketability discount to be applied in valuing a G&J share, and (3) G&J's cost of equity.

We shall describe their testimony with respect to their areas of disagreement.

B. Mr. McCoy's Testimony

1. Introduction

Mr. McCoy stated that his assignment was to determine the fair market value of small minority interests in the common stock of G&J. Mr. McCoy used three separate methods to determine that value: market price comparison method, discounted future free cash-flow method, and valuation by capitalization of earnings. Mr. McCoy gave

equal weight to the results reached under the second and third methods, but only one-third of that weight to the result reached under the first method. Mr. McCoy determined a weighted average value for a G&J share and, then, applied a discount for lack of marketability to arrive at the aforementioned value for a G&J share of $ 5,680.

2. Tax Affecting G&J's Earnings

Under the discounted future free cash-flow method, Mr. McCoy considered G&J to be an asset capable of producing cash-flows to its owners for an infinite number of periods. He determined the present value of G&J by, first, hypothesizing the available cash for each such period, second, discounting each such amount to reflect both the delay in payment and the risk of nonpayment, and third, summing the results.

Mr. McCoy testified that, in 1992, various professional associations published standards governing the conduct of professional business appraisers and that professional appraisers were ethically bound to follow those standards. Specifically, Mr. McCoy specified an appraisal foundation publication entitled the Uniform Standards of Professional Appraisal Practice (USPAP), which required business appraisers to be aware of, to understand, and correctly to employ recognized methods and techniques necessary to produce a credible result (the standards rule). Mr. McCoy further testified that, in order to comply with the standards rule, it was necessary for professional appraisers to "tax affect" the earnings of an S corporation in order to produce a credible business appraisal. To accomplish such tax affecting, Mr. McCoy introduced a fictitious tax burden,

equal to an assumed corporate tax rate of 40 percent, which he applied to reduce each future period's earnings, before such earnings were discounted to their present value.[2]

3. Lack of Marketability Discount

Mr. McCoy examined several studies that considered the lack of marketability of closely held and restricted securities. Mr. McCoy testified that, based on his examination, an average lack of marketability discount for shares that would eventually become freely tradable was "30%+". Mr. McCoy then concluded that a greater discount was required for the G&J shares because they were illiquid and not marketable.[3] Mr. McCoy testified that a discount rate

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[2] Sec. 11 imposes a tax on the income of every corporation. Additionally, the shareholders of a C corporation, defined in sec. 1361(a)(2) as any corporation which is not an S corporation, must include in gross income any dividends received from the C corporation, sec. 301(c)(1), thus giving rise to the claim that the income of a C corporation is subject to a double tax. Conversely, an S corporation (as defined in sec. 1361(a)(1)), generally is not subject to the sec. 11 tax. See sec. 1363(a). Instead, the items of income, loss, deduction, or credit, of the S corporation are passed through to the shareholders of the S corporation and are taken into account directly in computing their tax liabilities. See sec. 1366(a). Additionally, in Ohio, S corporations (such as G&J) are not subject to State income tax. See Ohio Rev. Code Ann. sec. 5733.09(B) (Banks-Baldwin 1995).

[3] Specifically, Mr. McCoy noted that, in addition to being closely held, the G&J shares were restricted as to transferability and were subject to a right of first refusal.

of at least 35 percent was required to compensate an owner for the lack of marketability of those shares.

4. Cost of Capital

Mr. McCoy testified that G&J's cost of equity capital was 19 percent.[4] He explained that G&J compared in size to very small capitalization public companies, which necessitated such a required rate of return. In addition to his market-derived required rate of return, Mr. McCoy further buttressed his opinion by summing the following component risk factors of G&J's cost of equity capital: (1) 2.1 percent as the risk-free rate of return, (2) 7 percent as an equity risk premium, (3) 1 percent as an adjustment for company specific risk, and finally (4) 4.8 percent as a small capitalization risk premium.[5]

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[4] In his oral testimony, Mr. McCoy distinguished between nominal and real numbers. Mr. McCoy testified that the difference was that the effects of inflation, which he opined to be 4 percent, were eliminated from nominal numbers to produce real numbers. Mr. McCoy explained that we must add his opined 4-percent inflation rate to his reported cost of equity (15 percent) in order to convert it back to a nominal number for comparative purposes. He, therefore, agreed that using nominal numbers, his calculated cost of equity was 19 percent compared to Dr. Bajaj's calculation of 15.5 percent.

[5] Although the sum of Mr. McCoy's risk factors is 15 percent, Mr. McCoy added 4 percent to his result in order to convert it to a nominal rate of return for comparison purposes. See supra note 4.

C. Dr. Bajaj's Testimony

1. Introduction

Dr. Bajaj also stated that his assignment was to determine the fair market value of certain minority blocks of stock in G&J. Dr. Bajaj relied principally on a discounted cash-flow approach to determine that value. To test the validity of his conclusions, he considered the values of companies he thought comparable to G&J. He also applied a discount for lack of marketability, and he arrived at the aforementioned value for a G&J share of $ 10,910.

2. Assumption of a Zero-Percent Corporate Tax Rate

Dr. Bajaj knew that G&J was an S corporation on the valuation date, and, based on information that he had received from G&J's management, he assumed that it would remain an S corporation indefinitely. He further assumed that virtually all of G&J's earnings would continue to be distributed to its shareholders. Dr. Bajaj determined that a zero-percent corporate tax rate was an appropriate assumption to make in determining the earnings of G&J available for distribution. Dr. Bajaj also ignored shareholder level taxes in arriving at his discount rate.

3. Lack of Marketability Discount

Dr. Bajaj testified that an appropriate discount for lack of marketability applicable to G&J's shares on the valuation date was 25 percent. In arriving at his conclusion, Dr. Bajaj first reviewed various commonly cited published studies that

examined marketability discounts. He divided the studies into two categories: (1) studies that analyzed sales of restricted stock by firms that also had publicly traded shares, and (2) studies that compared share prices observed in successful initial public offerings (IPOs). With regard to the first category, Dr. Bajaj concluded that, due to variations in characteristics of the observed firms and transactions, only about 10 to 15 percent of the observed discounts[6] could be attributed to a lack of marketability. With regard to the second category, Dr. Bajaj concluded that the published results were not useful in evaluating discount levels for two reasons. First, Dr. Bajaj testified that many of the pre-IPO private market transactions probably did not occur at fair market value. Second, Dr. Bajaj testified that examining only a selection of firms that carried out successful IPOs was a biased statistical sample, and that such bias would tend to increase the apparent "discount". Relying more on his own empirical analysis of lack of marketability discounts, and considering such factors as G&J's generous dividend policy and its greater marketability restrictions (i.e., the restrictive transfer agreements), Dr. Bajaj concluded that a conservative estimate of the lack of marketability discount for G&J's shares on the valuation date was 25 percent.

4. Cost of Capital

Dr. Bajaj used a 15.5-percent cost of equity and a 8.25- percent cost of debt to derive a 14.4-percent weighted

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[6] According to Dr. Bajaj, the studies that analyzed sales of restricted stock by firms that also had publicly traded shares demonstrated that the median discounts ranged from 10 to 40 percent.

cost of capital for G&J. He used the capital asset pricing model to derive his opined cost of equity. Dr. Bajaj used 7.46 percent as the risk- free rate of return,[7] 7.4-percent as the long-term market risk premium,[8] and 1.09 percent as G&J's beta coefficient.[9] Dr. Bajaj's cost of equity calculation was as follows: 7.46 + (1.09 * 7.4) = 15.5 percent.

Dr. Bajaj determined G&J's cost of debt capital by looking at G&J's real borrowing costs. In April 1991, G&J took on debt in part to fund an expansion. It borrowed the needed funds at 8.25 percent, which was three-quarters of a percent below the then prime rate of 9 percent.

D. Petitioners' Motion in Limine

Petitioners have moved to exclude Dr. Bajaj's testimony (the motion). First, petitioners argue that Dr. Bajaj's opinion as to the fair market value of a minority stock ownership interest in G&J is inadmissible because it was

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[7] Dr. Bajaj explained that the yield to maturity on 30-year Treasury securities was an appropriate measure of a risk-free rate, which, according to information published by the Federal Reserve was 7.46 percent as of July 31, 1992.

[8] Dr. Bajaj explained that the 7.4-percent long-term market risk premium was derived from historical data published by Ibbotson Associates, Inc.

[9] Dr. Bajaj defined beta as a measure of the tendency of a security's return to move with the overall market's return. He estimated G&J's beta from the betas for public firms operating in the soft drink industry for which published figures were available.

derived from the application of scientifically unreliable methodologies. See *Daubert v. Merrell Dow Pharm. Inc.*, 509 U.S. 579, 589, 125 L. Ed. 2d 469, 113 S. Ct. 2786 (1993)(under the Federal Rules of Evidence, the trial judge must ensure that any and all scientific testimony or evidence admitted is not only relevant, but is also reliable). Petitioners further argue that neither Dr. Bajaj's underlying data nor his empirical analysis has been published or otherwise submitted for peer review by the appraisal profession. Finally, petitioners argue that, in part, the data Dr. Bajaj relied upon was not available in 1992, and, therefore, a willing and knowledgeable buyer and seller could not, at that time, be expected to have relied on Dr. Bajaj's marketability discount analysis in arriving at a fair market value determination of G&J's stock. Petitioners cite *Estate of Newhouse v. Commissioner*, 94 T.C. 193 (1990), and *Estate of Mueller v. Commissioner*, T.C. Memo 1992-284, as authority for the proposition that we must reject Dr. Bajaj's new data and empirical analysis as a matter of law. We disagree.

In *Daubert v. Merrell Dow Pharm. Inc., supra* 509 U.S. at 585-587, the Supreme Court held that the "general acceptance" test, the dominant standard for determining the admissibility of novel scientific evidence at trial, was superseded by the adoption of the Federal Rules of Evidence. Fed. R. of Evid. 702 reads:

> If scientific, technical, or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue, a witness qualified as an expert by knowledge, skill, experience, training, or

> education, may testify thereto in the form of an opinion or otherwise.

Pursuant to Fed. R. of Evid. 702, the Court must assure that scientific evidence is not only relevant, but also reliable. *Daubert v. Merrell Dow Pharm., Inc., supra* at 589. *Daubert*, however, is not limited to evidence that is scientific only in the laboratory sense. Recently, in *Kumho Tire Co. v. Carmichael*, 526 U.S. 137, 119 S. Ct. 1167, 1171, 143 L. Ed. 2d 238 (1999), the Supreme Court made clear: Daubert's general holding -- setting forth the trial judge's general 'gatekeeping' obligation -- applies not only to testimony based on 'scientific' knowledge, but also to testimony based on 'technical' and 'other specialized' knowledge. Dr. Bajaj's testimony (as well as Mr. McCoy's) was of a technical nature. Therefore, Daubert is applicable here, and we have a gatekeeping role to perform.

As we have said, value is a question of fact. See *supra* sec. II. Dr. Bajaj has an opinion as to that fact, arrived by applying certain tools of financial analysis, primarily a discounted cash-flow analysis, which is a method of analysis also employed by Mr. McCoy. Petitioners do not claim that a discounted cash-flow analysis is an unreliable tool for determining the present value of one or more future cash-flows (e.g., the distributions of cash Dr. Bajaj assumed G&J would continue indefinitely). We have for many years relied on a discounted cash-flow analysis to determine the present value of one or more future cash-flows. See, e.g., *Plumb v. Commissioner*, 7 B.T.A. 295, 297 (1927); *Willamette Indus., Inc. v. Commissioner*, T.C. Memo 1990-339 (setting forth the algebraic formula to determine the present value of a future payment). When properly applied, a discounted cash-flow

analysis is a reliable tool for financial analysis. The difference in opinions as to value reached by the two expert witnesses, at least to the extent it is attributable to the discounted cash-flow approach, is exclusively the result of differences between them as to the values of certain variables, not a difference as to methodology. Therefore, since we find the discounted cash-flow analysis to be a reliable tool to determine the present value of one or more future cash-flows, we believe that petitioners' argument, to wit, that Dr. Bajaj's opinion is based on unreliable methodologies, is nonsensical.

Because we find that both parties' experts relied on the same acceptable valuation methodology, and that the areas of disagreement between the experts are merely factual disagreements over various factors and assumptions, we need not address further petitioners' second concern, that Dr. Bajaj's "method" has not been subjected to peer review.

Finally, we address petitioners' last contention, that the data Dr. Bajaj relied upon was not available in 1992 and, therefore, in calculating a discount for lack of marketability a willing buyer and seller could not have relied upon it. Dr. Bajaj's sample consisted of 157 observed transactions from January 1, 1980, to October 31, 1996. Seventy-eight of the transactions preceded the gift date, and 79 were announced subsequent to the gift date. Petitioners' reliance on *Estate of Newhouse v. Commissioner, supra,* and *Estate of Mueller v. Commissioner, supra,* is misplaced. In *Estate of Newhouse* we held: "[t]he focus of a valuation inquiry * * * is on the existing facts, circumstances, and factors at the valuation date that influence a hypothetical willing buyer and willing seller in determining a selling price." *Estate of Newhouse v. Commissioner*, 94 T.C. at 231. It is not improper, however,

to consider later events to the extent that such events may shed light upon a fact, circumstance, or factor as it existed on the valuation date. See, e.g., *Estate of Gilford v. Commissioner,* 88 T.C. 38, 52-53 (1987). We do not interpret Dr. Bajaj to have opined that a willing buyer and a willing seller would or could have relied upon the data he used on the gift date. Instead, Dr. Bajaj testified that, based on a survey and examination of similar transactions, including transactions that occurred after the gift date, we can determine with reasonable accuracy what willing buyers and willing sellers were doing on the valuation date. Dr. Bajaj testified

> it is methodologically appropriate to use the comprehensive sample I collected to estimate marketability discounts even though approximately half the sample consists of post-valuation date announcements because there is no reason to believe that the underlying economics of private placement would have changed after the valuation date.

We agree. Further, petitioners have not alleged that the observed lack of marketability discounts in similar private placement transactions would have changed after the valuation date.

Additionally, after performing an identical statistical analysis on only the prevaluation portion of his data sample, Dr. Bajaj reported a predicted discount similar to the discount

he predicted using his complete data.[10] For the foregoing reasons, petitioners' motion will be denied, and an appropriate order will be issued.

IV. Valuation of the Gift

1. Tax Affecting G&J's Earnings

A. Introduction

The decision whether to tax affect G&J's projected earnings under the discounted cash-flow approach accounts for the most significant differences between the parties' expert witnesses. In fact, Dr. Bajaj repeated his analysis, substituting a 40-percent corporate income tax rate for the zero-percent corporate rate he first assumed. Offsetting for interest payment deductions, Dr. Bajaj calculated that the resulting market capitalization dropped from $ 286 million to $ 188 million, a 34-percent reduction, which amount was within 10 percent of the weighted average value ($ 171,993,000) computed by Mr. McCoy.

Petitioners argue for tax affecting not only on the basis of the testimony of their expert witnesses, but also on the basis that respondent has advocated that adjustment and must be held to it.

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[10] In fact, the predicted discount associated with the prevaluation data was slightly lower than with the full sample.

B. Petitioners' Position

Petitioners introduced into evidence two internal documents of the Internal Revenue Service: (1) a valuation guide for income, estate, and gift taxes (the guide), and (2) an examination technique handbook for estate tax examiners (the handbook).

We read those excerpts as neither requiring tax affecting nor laying the basis for a claim of detrimental reliance. The guide, in relevant part, reads:

> * * *[S] corporations are treated similarly to partnerships for tax purposes. S Corporations lend themselves readily to valuation approaches comparable to those used in valuing closely held corporations. You need only to adjust the earnings from the business to reflect estimated corporate income taxes that would have been payable had the Subchapter S election not been made.

The handbook, in relevant part, reads:

> If you are comparing a Subchapter S Corporation to the stock of similar firms that are publicly traded, the net income of the former must be adjusted for income taxes using the corporate tax rates applicable for each year in question, and certain other items, such as salaries. These adjustments will avoid distortions when applying industry ratios such as price to Earnings.

Both statements lack analytical support, and we refuse to interpret them as establishing respondent's advocacy of tax-affecting as a necessary adjustment to be made in applying the discounted cash-flow analysis to establish the value of an S corporation.

Even if we were to interpret the excerpts as petitioners do, petitioners do not claim that the excerpts have the force of a regulation or ruling, nor have they shown the type of detrimental reliance that might work an equitable estoppel against respondent. Equitable estoppel is a judicial doctrine that precludes a party from denying his own acts or representations which induced another to act to his detriment. Estoppel is applied against the Commissioner with utmost caution and restraint. *Hofstetter v. Commissioner*, 98 T.C. 695, 700 (1992) (internal citations and quotation marks omitted). In any event: Detrimental reliance on the part of the party seeking to invoke estoppel is a key condition. *Id.* Petitioners have failed to prove that they relied on either the guide or the handbook in any way. Accordingly, respondent is not estopped from disregarding a fictitious corporate tax when valuing an S corporation.

C. Mr. McCoy's Testimony

Mr. McCoy lists eight costs or tradeoffs shareholders incur as a result of electing to be taxed as an S corporation. The enumerated costs or tradeoffs highlight three areas of concern, which "tax- affecting" is directed to address. First, Mr. McCoy addresses the possibility that, if an S corporation distributes less than all of its income, the actual distributions might be insufficient to cover the shareholders' tax obligations. As a theoretical matter, we do not believe that

"tax-affecting" an S corporation's projected earnings is an appropriate measure to offset that potential burden associated with S corporations. In any event, we do not think it is a reasonable assumption that G&J would not make sufficient distributions to cover its shareholders' tax liabilities. G&J had a strong growth record and a history of making cash distributions to shareholders that nearly equaled its entire income. Petitioners have not convinced us that it would be reasonable to assume G&J would not continue this practice.

Second, Mr. McCoy addresses the risk that an S corporation might lose its favorable S corporation status. We might consider an approach that sought to determine the probability of such an occurrence, and which utilized a tax rate equal to the product of such probability and the corporate tax rate in an effort to quantify that potential loss. We do not, however, think it is reasonable to tax affect an S corporation's projected earnings with an undiscounted corporate tax rate without facts or circumstances sufficient to establish the likelihood that the election would be lost.

Finally, Mr. McCoy argues that S corporations have a great disadvantage in raising capital due to the restrictions of ownership necessary to qualify for the S corporation election. This concern is more appropriately addressed in determining an appropriate cost of capital. In any event, it is not a justification for tax affecting an S corporation's projected earnings under a discounted cash-flow approach. r. McCoy has failed to put forward any cognizable argument justifying the merits of tax affecting G&J's projected earnings under a discounted cash-flow approach.

D. Mr. Wilhoite's Testimony

Mr. Wilhoite was asked to address whether, as of the valuation date, it was reasonable for Dr. Bajaj to value a G&J share, using the discounted cash-flow method, while assuming a zero-percent corporate tax rate. Mr. Wilhoite faults Dr. Bajaj for not taking into account the known payment of taxes in arriving at a value for the G&J shares. It is unclear, however, whether the known payment that Mr. Wilhoite has in mind is the avoided corporate level tax paid by a C corporation, or the shareholder level tax that results from the flowthrough of tax items to the shareholders of an S corporation.

The clearest argument Mr. Wilhoite put forward explaining why it is appropriate to "tax-affect" an S corporation's earnings is:

> In effect, an S corporation is committed to making distributions to shareholders sufficient to cover individual tax liabilities on allocated S corporation earnings in the same fashion that a C corporation is committed to making tax payments to the Service to cover corporate tax liabilities on reported taxable earnings. * * * Whether the outflow is a cash distribution made by an S corporation to satisfy shareholders' tax liabilities, or the direct payment of a tax liability by a C corporation, the decrease in cash experienced by either entity represents a known payment which reduces the availability of cash which could otherwise be used to maintain or expand

> existing operations. Such a decrease must be taken into consideration when valuing an entity, whether it is structured as a C corporation or an S Corporation.

Mr. Wilhoite's testimony is not persuasive. On redirect examination, Mr. Wilhoite stated: [Y]ou deduct the taxes that would be paid if the company were structured as a C corporation; and that leaves you with a distributable amount of earnings. Further, Mr. Wilhoite had the following discussion with the Court:

> Mr. Wilhoite: We're dealing with a stock of a corporation, G&J. And G&J is an S corporation. And G&J has generated significant earnings up until the date of the valuation * * * and all of those earnings have been distributed to the shareholders.
>
> The Court: Um-hmm.
>
> Mr. Wilhoite: But every dollar of earnings for G&J, in any particular year, has to go to the IRS. Whether it goes through the shareholders or directly, it has to go to the IRS.
>
> So, what's left above the tax that they're paying to the IRS is the true distribution to the shareholder, and also represents the true available cash that the company can distribute.

It is possible that Mr. Wilhoite is arguing that, in valuing an S corporation, the avoided C corporation tax must

be taken into account as a hypothetical expense, in addition to the shareholder level taxes actually imposed on the S corporation's shareholders. Indeed, that is the position taken by Mr. McCoy. Mr. Wilhoite has failed to convince us, however, that Dr. Bajaj should have applied a hypothetical corporate tax rate in excess of the zero- percent actual corporate tax rate he did apply. He has not convinced us that such an adjustment is appropriate as a matter of economic theory or that an adjustment equal to a hypothetical corporate tax is an appropriate substitute for certain difficult to quantify disadvantages that he sees attaching to an S corporation election. We believe that the principal benefit that shareholders expect from an S corporation election is a reduction in the total tax burden imposed on the enterprise. The owners expect to save money, and we see no reason why that savings ought to be ignored as a matter of course in valuing the S corporation.

Although perhaps less likely, Mr. Wilhoite may believe that, as a matter of proper application of a present value analysis, Dr. Bajaj was required to tax affect G&J's expected distributions on account of the expected tax burden to be borne by its shareholders. Dr. Bajaj assumed that G&J would continue to distribute all of its earnings annually. He made no explicit adjustment for any shareholder level taxes, although, undoubtedly, he knew such taxes would be due. Dr. Bajaj did not, however, ignore shareholder level taxes. He simply disregarded them both in projecting G&J's available cash and in determining the appropriate discount rate. The present value of any future (deferred) cash-flow is a function of three variables. (1) the amount of the cash-flow, (2) the

discount rate, and (3) the period of deferral.[11] The discount rate reflects the return, over time, to the investor on the amount invested (commonly expressed as a rate of interest). If, in determining the present value of any future payment, the discount rate is assumed to be an after-shareholder-tax rate of return, then the cash-flow should be reduced (tax affected) to an after-shareholder-tax amount. If, on the other hand, a preshareholder-tax discount rate is applied, no adjustment for taxes should be made to the cash-flow.[12] Since, in applying his discounted cash-flow approach, Dr. Bajaj assumed a preshareholder-tax discount rate, he made no error in failing to tax affect the expected cash-flow. If Mr. Wilhoite's criticism is based on his assumption that Dr. Bajaj wrongly disregarded shareholder level taxes, then he is in error.

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[11] PV = C/(1+r)(n), where PV equals the present value, r equals the discount rate, C equals the cash-flow, and n equals the number of periods of deferral.

[12] Thus, assume that, in consideration for today investing $ 100, an investor is to receive $ 110 in 1 year. The interest rate implicit in this example is 10 percent. Assume that the investor's return will be subject to a 40-percent tax. If the investor considers that his after-tax return will be $ 106 and assumes an after-tax discount rate of 6 percent, then the present value of the after-tax cash flow of $ 106 would be $ 100. If, on the other hand, the investor considers that his pretax return will be 10 percent, then the present value of the pretax cash flow of $ 110 would also be $ 100. Hence, there is no difference in result.

2. Lack of Marketability Discount

We have considered the expert testimony on the lack of marketability issue, and we weigh that testimony in light of the experts' qualifications and other credible evidence. See *Estate of Newhouse v. Commissioner*, 94 T.C. at 217. While we recognize the severity of the restrictions imposed both by law and by and among the existing shareholders, which limited the marketability of G&J's shares in 1992, we find Dr. Bajaj's testimony to be thorough and more persuasive than Mr. McCoy's. Taking account of the inherently subjective and imprecise nature of the investigation,[13] we find that an appropriate lack of marketability discount for the gifted shares on the gift date was 25 percent.

3. Cost of Capital

The final significant area of contention between the parties is the appropriate cost of equity capital to be used for purposes of valuing the G&J shares. Based on the opinions of their respective experts, petitioners and respondent assert

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[13] Both parties criticize the opposing opinion evidence testimony as being arbitrary and unsupported. Petitioners note that, at first, Dr. Bajaj, in his report, carefully estimated a "conservative" lack of marketability discount of 13 percent. Then, arbitrarily, based on "several additional facts", and with less than half a page of discussion, he "virtually doubles" his estimate and concludes that an appropriate discount is 25 percent. Respondent, in turn, notes that the Business Valuations report relies on studies which examined biased statistical data, and studies which misinterpret observed results.

G&J's appropriate cost of equity capital was 19 percent and 15.5 percent, respectively.

It is unclear how Mr. McCoy arrived at 19 percent. Mr. McCoy begins by stating: The required rate of return is determined by comparison to rates of return on investments of similar risk. He then ranks various investments by quality, as of December 1991, beginning with long-term Government bonds and ending with the category extreme risk. One ranking consists of CC Bond and Very Small Cap. Companies, which shows Yield to Maturity of 18+. The next higher ranking, CCC Bond and Small Cap. Companies shows a Yield to Maturity of 21+. Mr. McCoy testified that he chose 19 percent because it fell within the range of yields to maturity for very small capitalization companies. He also testified that he checked his conclusion by building up the required rate of return from various factors, including an Expected Small Stock Risk Premium of 4.8 percent, the source of which, allegedly, was Stocks, Bonds, Bills and Inflation: 1992 Yearbook, Ibbotson Associates Inc. (1992). It is not clear how Mr. McCoy defines "Very Small Cap. Companies". At trial, Mr. McCoy in fact admitted that G&J did not fall into the Ibbotson definition of a small company. We, therefore, have no confidence in the foundation of Mr. McCoy's analysis on this issue. We are not bound by the opinion of any expert witness and will accept or reject expert testimony in the exercise of sound judgment. See *Helvering v. National Grocery Co.*, 304 U.S. 282, 295, 82 L. Ed. 1346, 58 S. Ct. 932 (1938); *Estate of Hall v. Commissioner*, 92 T.C. 312, 338 (1989). Petitioners have not met their burden of demonstrating that an appropriate cost of equity capital for G&J on the gift date was 19 percent.

We find Dr. Bajaj's testimony to be thorough and convincing. Dr. Bajaj opined a 14.4-percent weighted average cost of capital for G&J as of the valuation date. He used the capital asset pricing model to derive an appropriate cost of equity capital, and he used G&J's real borrowing costs to derive an appropriate cost of debt capital for G&J as of the valuation date. Indeed, G&J's 8.25-percent borrowing rate in 1991 was three-quarters of a percent below the prime rate. By the valuation date, the prime rate had dropped to 6 percent; therefore we believe that Dr. Bajaj's opinion errs on the generous side, if at all. We accord significant weight to Bajaj's opinion.

Further, the category immediately above "Very Small Cap. Companies" in Mr. McCoy's rankings is entitled "Small Cap. Companies", which, according to McCoy, has a reported required rate of return of 15 percent. That figure is associated with a nominal category that is not inconsistent with petitioners' assertions (that G&J was a "small company"), and it is in harmony with respondent's asserted value. Therefore, we conclude that an appropriate cost of equity capital for G&J on the gift date was 15.5 percent.

V. Conclusion

For the foregoing reasons, we conclude that the value of the gifted shares on the gift date was $ 10,910 per share.

Decisions will be entered under Rule 155.

APPENDIX D

STATUTORY AND REGULATORY PROVISIONS

TITLE 26. INTERNAL REVENUE CODE
SUBTITLE B. ESTATE AND GIFT TAXES
CHAPTER 12. GIFT TAX
SUBCHAPTER B. TRANSFERS

26 USCS § 2512 (2002)

§ 2512. Valuation of gifts.

(a) If the gift is made in property, the value thereof at the date of the gift shall be considered the amount of the gift.

(b) Where property is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration shall be deemed a gift, and shall be included in computing the amount of gifts made during the calendar year.

(c) Cross reference. For individual's right to be furnished on request a statement regarding any valuation made by the Secretary of a gift by that individual, see section 7517.

APPENDIX E

TITLE 26 -- INTERNAL REVENUE

CHAPTER I -- INTERNAL REVENUE SERVICE, DEPARTMENT OF THE TREASURY

SUBCHAPTER B -- ESTATE AND GIFT TAXES

PART 25 -- GIFT TAX; GIFTS MADE AFTER DECEMBER 31, 1954

TRANSFERS

26 CFR 25.2512-1

§ 25.2512-1 Valuation of property; in general.

Section **2512** provides that if a gift is made in property, its value at the date of the gift shall be considered the amount of the gift. The value of the property is the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts. The value of a particular item of property is not the price that a forced sale of the property would produce. Nor is the fair market value of an item of property the sale price in a market other than that in which such item is most commonly sold to the public, taking into account the location of the item wherever appropriate. Thus, in the case of an item of property made the subject of a gift,

which is generally obtained by the public in the retail market, the fair market value of such an item of property is the price at which the item or a comparable item would be sold at retail. For example, the value of an automobile (an article generally obtained by the public in the retail market) which is the subject of a gift, is the price for which an automobile of the same or approximately the same description, make, model, age, condition, etc., could be purchased by a member of the general public and not the price for which the particular automobile of the donor would be purchased by a dealer in used automobiles. Examples of items of property which are generally sold to the public at retail may be found in §25.2512-6. The value is generally to be determined by ascertaining as a basis the fair market value at the time of the gift of each unit of the property. For example, in the case of shares of stocks or bonds, such unit of property is generally a share or a bond. Property shall not be returned at the value at which it is assessed for local tax purposes unless that value represents the fair market value thereof on the date of the gift. All relevant facts and elements of value as of the time of the gift shall be considered. Where the subject of a gift is an interest in a business, the value of items of property in the inventory of the business generally should be reflected in the value of the business. For valuation of interests in businesses, see § 25.2512-3. See § 25.2512-2 and §§ 25.2512-4 through 25.2512-6 for further information concerning the valuation of other particular kinds of property. See section 2701 and the regulations at § 25.2701 for special rules for valuing transfers of an interest in a corporation or a partnership and for the treatment of unpaid qualified payments at the subsequent transfer of an applicable retained interest by the transferor or by an applicable family member. See section 2704(b) and the regulations at § 25.2704-2 for special valuation rules where an interest in property is subject to an applicable restriction.

APPENDIX F

CODE OF FEDERAL REGULATIONS

TITLE 26 -- INTERNAL REVENUE

CHAPTER I -- INTERNAL REVENUE SERVICE, DEPARTMENT OF THE TREASURY

SUBCHAPTER B -- ESTATE AND GIFT TAXES

PART 25 -- GIFT TAX; GIFTS MADE AFTER DECEMBER 31, 1954

TRANSFERS

26 CFR 25.2512-2

§ 25.2512-2 Stocks and bonds.

(a) In general. The value of stocks and bonds is the fair market value per share or bond on the date of the gift.

(b) Based on selling prices. (1) In general, if there is a market for stocks or bonds, on a stock exchange, in an over-the-counter market or otherwise, the mean between the highest and lowest quoted selling prices on the date of the gift is the fair market value per share or bond. If there were no sales on the date of the gift but there were sales on dates within a reasonable period both before and after the date of the gift, the fair market value is determined by taking a weighted average of the means between the highest and lowest sales on the nearest date before and the nearest date after the

date of the gift. The average is to be weighted inversely by the respective numbers of trading days between the selling dates and the date of the gift. If the stocks or bonds are listed on more than one exchange, the records of the exchange where the stocks or bonds are principally dealt in should be employed if such records are available in a generally available listing or publication of general circulation. In the event that such records are not so available and such stocks or bonds are listed on a composite listing of combined exchanges available in a generally available listing or publication of general circulation, the records of such combined exchanges should be employed. In valuing listed securities, the donor should be careful to consult accurate records to obtain values as of the date of the gift. If quotations of unlisted securities are obtained from brokers, or evidence as to their sale is obtained from the officers of the issuing companies, copies of letters furnishing such quotations or evidence of sale should be attached to the return.

(2) If it is established with respect to bonds for which there is a market on a stock exchange, that the highest and lowest selling prices are not available for the date of the gift in a generally available listing or publication of general circulation but that closing prices are so available, the fair market value per bond is the mean between the quoted closing selling price on the date of the gift and the quoted closing selling price on the trading day before the date of the gift. If there were no sales on the trading day before the date of the gift but there were sales on dates within a reasonable period before the date of the gift, the fair market value is determined by taking a weighted average of the quoted closing selling prices on the date of the gift and the nearest date before the date of the gift. The closing selling price for the date of the gift is to be weighted by the respective number of trading

days between the previous selling date and the date of the gift. If there were no sales within a reasonable period before the date of the gift but there were sales on the date of the gift, the fair market value is the closing selling price on the date of the gift. If there were no sales on the date of the gift but there were sales within a reasonable period both before and after the date of the gift, the fair market value is determined by taking a weighted average of the quoted closing selling prices on the nearest date before and the nearest date after the date of the gift. The average is to be weighed inversely by the respective numbers of trading days between the selling dates and the date of the gift. If the bonds are listed on more than one exchange, the records of the exchange where the bonds are principally dealt in should be employed. In valuing listed securities, the donor should be careful to consult accurate records to obtain values as of the date of the gift.

*** 152465** (3) The application of this paragraph may be illustrated by the following examples:

Example (1). Assume that sales of stock nearest the date of the gift (Friday, June 15) occurred two trading days before (Wednesday, June 13) and three trading days after (Wednesday, June 20) and on these days the mean sale prices per share were $ 10 and $ 15, respectively. The price of $ 12 is taken as representing the fair market value of a share of stock as of the date of the gift

$$[(3 \text{ X } 10)+(2 \text{ X } 15)]/5$$

Example (2). Assume the same facts as in example 1 except that the mean sale prices per share on June 13 and June 20 were $ 15 and $ 10 respectively. The price of $ 13 is taken as representing the fair market value of a share of stock as of the date of the gift

$$[(3 \text{ X } 15)+(2 \text{ X } 10)]/5$$

Example (3). Assume that on the date of the gift (Tuesday, April 3, 1973) the closing selling price of certain listed bonds was $ 25 per bond and that the highest and lowest selling prices are not available in a generally available listing or publication of general circulation for that date. Assume further, that the closing selling price of such bonds was $ 21 per bond on the day before the date of the gift (Monday, April 2, 1973). Thus, under paragraph (b)(2) of this section, the price of $ 23 is taken as representing the fair market value per bond as of the date of the gift

$$[(25+21)]/2$$

Example (4). Assume the same facts as in example 3 except that there were no sales on the day before the date of the gift. Assume further, that there were sales on Thursday, March 29, 1973, and that the closing selling price on that day was $ 23. The price of $ 24.50 is taken as representing the fair market value per bond as of the date of the gift

$$[(1 \text{ X } 23)+(3 \text{ X } 25)]/4$$

Example (5). Assume that no bonds were traded on the date of the gift (Friday, April 20). Assume further, that sales of bonds nearest the date of the gift occurred two trading days before (Wednesday, April 18) and three trading days after (Wednesday, April 25) the date of the gift and that on these two days the closing selling prices per bond were $ 29 and $ 22, respectively. The highest and lowest selling prices are not available for these dates in a generally available listing or publication of general circulation. Thus, under paragraph (b)(2) of this section the price of $ 26.20 is taken as representing the fair market value of a bond as of the date of the gift

* 152466 [(3 X 29)+(2 X 22)]/5

(c) Based on bid and asked prices. If the provisions of paragraph (b) of this section are inapplicable because actual sales are not available during reasonable period beginning before and ending after the date of the gift, the fair market value may be determined by taking the mean between the bona fide bid and asked prices on the date of the gift, or if none, by taking a weighted average of the means between the bona fide bid and asked prices on the nearest trading date before and the nearest trading date after the date of the gift, if both such nearest dates are within a reasonable period. The average is to be determined in the manner described in paragraph (b) of this section.

(d) Where selling prices and bid and asked prices are not available for dates both before and after the date of gift. If the provisions of paragraphs (b) and (c) of this section are inapplicable because no actual sale prices or quoted bona fide bid and asked prices are available on a date within a reasonable period before the date of the gift, but such prices are available on a date within a reasonable period after the date of the gift, or vice versa, then the mean between the highest and lowest available sale prices or bid and asked prices may be taken as the value.

(e) Where selling prices or bid and asked prices do not represent fair market value. In cases in which it is established that the value per bond or share of any security determined on the basis of the selling or bid and asked prices as provided under paragraphs (b), (c), and (d) of this section does not represent the fair market value thereof, then some reasonable modification of the value determined on that basis or other relevant facts and elements of value shall be considered in determining fair market value. Where sales at or near the date

of the gift are few or of a sporadic nature, such sales alone may not indicate fair market value. In certain exceptional cases, the size of the block of securities made the subject of each separate gift in relation to the number of shares changing hands in sales may be relevant in determining whether selling prices reflect the fair market value of the block of stock to be valued. If the donor can show that the block of stock to be valued, with reference to each separate gift, is so large in relation to the actual sales on the existing market that it could not be liquidated in a reasonable time without depressing the market, the price at which the block could be sold as such outside the usual market, as through an underwriter, may be a more accurate indication of value than market quotations. Complete data in support of any allowance claimed due to the size of the block of stock being valued should be submitted with the return. On the other hand, if the block of stock to be valued represents a controlling interest, either actual or effective, in a going business, the price at which other lots change hands may have little relation to its true value.

(f) Where selling prices or bid and asked prices are unavailable. If the provisions of paragraphs (b), (c), and (d) of this section are inapplicable because actual sale prices and bona fide bid and asked prices are lacking, then the fair market value is to be determined by taking the following factors into consideration:

(1) In the case of corporate or other bonds, the soundness of the security, the interest yield, the date of maturity, and other relevant factors; and

(2) In the case of shares of stock, the company's net worth, prospective earning power and dividend-paying capacity, and other relevant factors.

Some of the "other relevant factors" referred to in subparagraphs (1) and (2) of this paragraph are: The goodwill of the business; the economic outlook in the particular industry; the company's position in the industry and its management; the degree of control of the business represented by the block of stock to be valued; and the values of securities of corporations engaged in the same or similar lines of business which are listed on a stock exchange. However, the weight to be accorded such comparisons or any other evidentiary factors considered in the determination of a value depends upon the facts of each case. Complete financial and other data upon which the valuation is based should be submitted with the return, including copies of reports of any examinations of the company made by accountants, engineers, or any technical experts as of or near the date of the gift.

[*T.D. 6334, 23 FR 8904, Nov. 15, 1958; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 7327, 39 FR 35355. Oct. 1, 1974; T.D. 7432, 41 FR 38769, Sept. 13, 1976*]